MAKING THE MOST OF CORPORATE RESTRUCTURING FOR MIDDLE-MARKET COMPANIES

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Companies seeking chapter 11 bankruptcy protection have the advantage of restructuring their financial obligations under the one of the world's most effective, and complex, insolvency systems. However, for middle-market companies seeking to restructure their debt, the chapter 11 process can be another story. Middle-market companies face specific challenges that differ in scale and proportion to large, mega corporations.

In recent months, the COVID-19 pandemic has multiplied these challenges, and with that, adding new layers of complexity for middle-market companies undergoing corporate restructuring. Furthermore, the forecasted wave of corporate bankruptcies that is expected to hit in the coming months will undoubtedly drag many of them into insolvency. While in some cases they may need to find an alternative path to restructuring, middle-market companies can find their way through chapter 11 with a successful outcome.

The Pitfalls of Chapter 11 Bankruptcy for Middle-Market Companies

A common misperception exists in the corporate bankruptcy community that middle-market bankruptcies are not complicated due to their smaller size and scope. However, they are not necessarily "easy," and in fact, the bankruptcy aspect of the case is identical whether it is a middle-market borrower or a mega, publicly owned company. The middle-market company may involve fewer affected parties, but the legal issues are not different, which presents equally challenging complexities when compared to bankruptcies involving larger companies.

Among their unique challenges, middle-market companies often lack internal resources and infrastructure within their debtor companies, particularly in the financial and accounting department. This often stems from inconsistent or unreliable books and records, especially when bookkeepers may be used instead of accountants, or the company was a wildly successful start-up that grew too fast to keep pace with its internal needs. Smaller companies also may not have access to enterprise-level accounting and people management software which can lead to reporting issues for monthly operating reports (MORs), schedules of assets and liabilities and schedules of financial affairs (SOFA), and litigation support needs. With less training and staffing in the finance department, financials also may not be professionally audited or even reliable.

The founders, or families of founders, of middle-market companies can also complicate matters in the manner with which they handle financial affairs surrounding the company. They may have an elevated level of control over their employees, sometimes even following their departure from the company, and take certain actions with less oversight and involvement from others. In some instances, they may even put aside potential wrongdoing, or cut a deal because they have personal relationships that may make the difference between business success and business failure. These types of control mechanisms lead to investigation and litigation

that add time and expense to a bankruptcy case. Complicating matters further, it is not uncommon for the company's capital contributions to come from the founder, and especially just before filing secured debt, giving rise to potential debt equity re-characterization issues and breach of fiduciary duty allegations that only complicate an already difficult process.

Fraudulent transfer issues can arise within middle-market bankruptcies as pre-petition transactions in smaller companies typically do not involve business brokers and investment bankers, and the founders may be in control of the entities involved in these transfers without any oversight. There may be other debtor and non-debtor entities controlled by the founder that are engaged in intercompany transactions, also potentially giving rise to fraudulent transfers. Further damage can be caused if the transaction was not conducted for reasonably equivalent value, or the company was rendered insolvent or dangerously undercapitalized as a result. If post-petition resources are limited, there may be insufficient funds to investigate all of the transactions in question thoroughly, and there may be an unwillingness to pursue claims on a contingency fee or hybrid contingency-fee basis; thus, limiting the available exit options for the chapter 11 debtor to emerge from bankruptcy.

In some middle-market bankruptcies, founders treat the debtor's estate as their personal piggy bank without any thought of how their transactions may affect creditors, and without any awareness or consideration of creditor's rights. This is especially true when the company is insolvent, and an owner's duty shifts to all creditors and not just the owners of the company. For instance, in the recent case of a substance abuse clinic undergoing bankruptcy, the debtors purchased its facilities several years prior to the bankruptcy, and while the transaction was paid in full, the property was titled in the owner's name instead of the business name. This may have been necessary initially to obtain a mortgage at a lower interest rate but offers an example of the types of transactions that will be challenged and are more likely to exist in a middle-market bankruptcy case. Middle-market companies are usually privately held without any SEC reporting requirements, which means it can be harder to determine what actually happened pre-petition, increasing the potential for creditor paranoia, anger and resistance. Without public records, there may be misinformation circulating among involved parties based on what has been seen in the press or leaked out to creditors. In some instances, first-day declarations, which can serve to clarify facts of the case, are not even filed, making matters worse. Full disclosure, regardless of the size of the case, is mandated in chapter 11 bankruptcies.

Unlike their mega case counterparts, smaller companies typically lack the resources to hire a chief restructuring officer (CRO) or sophisticated financial advisory team skilled in restructuring to assist with the process. A lack of familiarity with bankruptcy processes among the founders and leadership of middle-market companies can cause unexpected hurdles and delays and actually lead to increased professional fees as the company relies more on counsel's assistance for routine bankruptcy tasks. There may be heightened emotionalism on the part of founders, directors, and officers, with a greater need for handholding by professionals and a greater risk of key employees who cannot be replaced jumping ship. Creditors may also be less experienced with legal and bankruptcy procedures, which can create additional layers of complexity and needless litigation.

Middle-market bankruptcies often struggle due to limited access to funding for chapter 11. Traditional DIP financing sources might be completely unavailable, and there is a greater possibility that there will not be financial or strategic investors willing to buy the business. In addition, there may not be the wherewithal to retain an investment banker to properly market the assets. As there may be limited funds to hire the needed professionals in the case, creditor interests and the viability of the business to survive as a going-concern can be at high-risk.

Although the common sentiment is that professional fees should be lower in mid-to-small market cases, that is not necessarily the case. Given the reliance on professionals as a result of the company's unfamiliarity with bankruptcy, it is not uncommon for professional fees to actually be higher in some middle-market bankruptcies. Having said that, in some lower middle-market cases, professionals have agreed not to be paid in full on the chapter 11 plan effective date even though they are entitled to because there are insufficient funds to pay them at that point. In order to achieve a confirmable and feasible chapter 11 plan, professionals sometimes are asked to waive a portion of their fees or agree to be paid post-effective date so unsecured creditors will receive a distribution.

In addition, there may be limited resources to retain or fairly compensate creditors' committee counsel and financial advisors. Without these, creditors may be left in the dark and subjected to inappropriate conduct by the debtor post-petition. Or if a creditors' committee hires counsel and a financial advisor, the cost of doing so can dwarf any benefit of doing so and, as such, leave a bankruptcy case administratively insolvent. Even if there is sufficient funding at the onset, creditor issues can potentially kill the business if the case drags on for an extended amount of time and the business cannot sustain that level of fees, or if protracted litigation ensues and eats through any available proceed from a

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sale of the company's assets. Therefore, it is important for debtor's counsel to be open and transparent and to build trust and confidence early in the case to avoid a creditor revolt or a motion for a chapter 11 conversion or trustee.

To compound matters, middle-market companies are less likely to have directors & officers (D&O) insurance coverage, or at least in a sufficient amount, reducing the likelihood that claims are collectable against founders, particularly if the founders are essential to the success of the go-forward business. A portion of founders may also have personal guaranties related to debt and other obligations, but the value and collectability of such guaranties may be of suspect value given the demise of the company.

As the case progresses, business competitors, co-investors, and litigation targets may file motions and objections to obstruct and slow down the process and increase the cost of bankruptcy for tactical purposes. Such delays make the viability of the chapter 11 case suspect and often taints the Court's view of the debtor.

On other fronts, the venue for middle-market bankruptcies may be less relevant than it is for larger companies because filing in the jurisdictions with familiarity with chapter 11 processes, such as the Southern District of New York or the Districts of Delaware or Houston, may not be an option. Although there are other competent jurisdictions, they may have more administrative issues at the court-level given that they do not confront middle-market or mega chapter 11 cases on a regular basis. When there is a choice, in addition to other considerations such as applicable Circuit law, debtors should consider filing in jurisdictions where the courts have a higher volume of chapter 11 cases and where there is likely to be greater efficiencies and experience.

COVID-19 Pandemic Adds Complexity to Middle-Market Bankruptcies

The fall-out from the COVID-19 pandemic has created new complications for middle-market companies seeking to restructure under chapter 11. Under the additional burdens and insurmountable debt imposed by the economic shutdown to contain the outbreak, some distressed middle-market companies are throwing in the towel and seeking to liquidate their assets and operations rather than continue as a going-concern. In fact, for some retailers, plans to "re-open" are focused on how best to implement an orderly liquidation of inventory rather than returning to any form of profitability. Most of these companies were in financial distress prior to the pandemic, but business closures forced them out of the market.

The closure of "non-essential" businesses created a new obstacle to business operations within chapter 11 as debtors may linger in bankruptcy without the ability to comply with their rent, payroll, and other related post-petition obligations. As seen in recent cases, some have requested a "motion to pause" to delay their rent obligations in hopes that they can resume them at a time when the economy and their unique circumstances will improve and certain Bankruptcy Courts have been accommodating to such requests, thus further demonstrating that as courts of equity, Bankruptcy Courts typically have the best interests of the business in mind.

While the Coronavirus Aid, Relief and Economic Security Act's (CARES Act) Paycheck Protection Program (PPP) is intended to serve as a lifeline for struggling small and middle-market companies, it also has brought new headaches for those who are considering or undergoing chapter 11. As the Small Business Administration (SBA) has deemed that companies undergoing bankruptcy are ineligible for the funds, corporate debtors are filing suits against the SBA claiming that these funds should be made available to them. While some courts have granted decisions in their favor, this adds yet another hurdle to the process and as of this article no chapter 11 debtor actually received such funding while in chapter 11. Furthermore, larger middle market companies must consider how the public will perceive their acceptance of PPP funds, as larger companies receiving the funds have faced backlash from consumers and others who feel that the loans should be reserved for smaller companies with fewer financing options. Finally, no one yet knows how the SBA will enforce the rules associated with PPP loans when things calm down and there once again is time to investigate any wrongdoing, whether purposeful or not.

Alternatives to Chapter 11 for Middle-Market Companies

While the obstacles facing middle-market companies are numerous and may seem daunting, they are not insurmountable, even in the wake of the COVID-19 crisis. These companies can still find their way through a successful chapter 11 process. However, for middle-market companies that are not equipped to navigate a traditional chapter 11 restructuring due to these potential pitfalls, there are alternatives they may consider with the support of their team of professionals and advisors. Each of these alternatives may also present their own set of challenges and must be evaluated carefully, particularly in the light of the impact of the COVID-19 pandemic on the economic environment.

For companies seeking to sell their assets to escape from unsurmountable debt levels, section 363 of the U.S. Bankruptcy Code offers a mechanism under which they can efficiently execute this strategy while in chapter 11. While this approach can pose additional costs and generally requires 45-90 days, it also offers

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debtors a more streamlined sale process and significant benefits, including the ability to assume and assign leases and sell the assets free and clear of liens, claims, and encumbrances. As Court approval is required, any concerns or challenges regarding the sale are resolved prior to closing and assure buyers that they are purchasing the assets with limited risk of successor liability. Additionally, chapter 11 provides a forum to de-lever a distressed balance sheet via a plan of reorganization, which can be done in an expedited time frame if provided the ability to craft such plan and file early in the case.

An assignment for the benefit of creditors (ABC) offers another alternative for middle-market companies seeking a distressed sale. Under an ABC, the company assigns its assets to a designated independent third party who liquidates such assets and distributes the proceeds to creditors, typically in a manner similar to the Absolute Priority Rule in chapter 11. Unlike a 363-bankruptcy sale, an ABC can proceed more quickly, within as short as 10 days of the assignment, and is far less costly to administer. However, there may be challenges raised following the sale, as assets may not be sold free and clear of liens and the company loses control over the sale of such assets. There is also no automatic stay to protect the assignee from litigation or being forced into an involuntary bankruptcy.

State or federal receiverships can provide a cost-effective solution for middle-market companies seeking to resolve debt and address business challenges. They are most often used in situations where the business has limited opportunity to continue as a going-concern or where fraudulent issues have presented roadblocks. Under a receivership, the state or federal court appoints a receiver to administer and, in some instances, liquidate the estate of a troubled company. With the primary goal of protecting the interests of stakeholders and preserving the company's estate, the receiver follows an appointment order from the presiding judge to recover value for the company and its creditors.

Some middle-market companies may also seek to resolve their debt obligations through Article 9 of the Uniform Commercial Code (UCC), which provides a mechanism by which lenders and secured creditors can create and foreclose on their security interests in the debtor. As a result of recent events, when faced with a situation where a business cannot re-open or be sold for significant value, this may be the most cost-efficient means for a company to exit the business operations. Lenders typically sell the business to a third party via a "friendly foreclosure." While the selling company cannot be related to the purchaser, it is not uncommon for purchasers to hire the management team of the selling company to continue to operate the business affairs. While Article 9 is most advantageous to secured lenders, savvy companies may be able to structure transactions to third parties via "friendly foreclosure" to maximize the value of extremely distressed assets.

Best Practices for Middle-Market Chapter 11 Bankruptcies

Despite the challenges facing them, middle-market companies can indeed find a successful pathway and outcome through chapter 11 with strategies and solutions to circumvent obstacles whenever possible to make the most of the restructuring process. The following best practices can help debtors and professionals find greater success.

- **Plan ahead and be prepared for the obstacles and issues that may occur in middle-market bankruptcies.** The biggest problem with most middle-market bankruptcies is that the owners and management team realized way too late that they needed to file bankruptcy. While not every case will present extreme challenges, restructuring teams can make the most of middle-market business reorganizations by anticipating roadblocks and averting them before they cause significant delays or problems.
- **Maintain transparency throughout the process.** Chapter 11 is an open forum. Assets, liabilities, transactions, and daily business operations will be made public. Being transparent with creditors, the United States Trustee, and the Court is paramount to a successful chapter 11 case.
- **Enlist the support of experienced professionals who are familiar with the nuances of middle-market bankruptcy.** There are unique challenges involved in middle-market bankruptcies and having an experienced, seasoned team of professionals to deal with them will help the debtor to more successfully navigate them. The cost structure of a middle-market bankruptcy is vastly different than a

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mega case and restructuring professionals familiar with that model are a necessity.

- **Confirm the financial support is there to achieve the goals of the case.** With all the variables and risks that exist within a middle-market bankruptcy, it's important for professionals to understand going into each case that there is ample funding for their fees and retainers.

Conclusion

The journey through corporate restructuring may not be an easy one for middle-market companies, however, there is hope that they can navigate the process to resolve their financial and operational issues by being aware of the challenges as well as the alternatives. To be sure, the COVID-19 pandemic has cast a shadow across the economic landscape that will have a significant impact on the ability of middle-market companies and bankruptcies to succeed, yet those who approach corporate restructuring strategically will have a fighting chance to emerge leaner and stronger.

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Christopher Ward has represented clients in corporate bankruptcy, financial restructuring, bankruptcy litigation, and distressed asset sales for the last two decades. As Chair of the Bankruptcy and Restructuring Practice and Managing Shareholder of the Delaware office of Polsinelli, Christopher routinely tackles financial restructurings, litigation, and distressed asset sales with a creative and aggressive approach not only in Chapter 11, but in non-bankruptcy alternatives. He specializes in representing distressed borrowers and Chapter 11 debtors, as evidenced by his engagements in Lucky's Market, Bayou Steel Group, Elements Behavioral Health, Orchids Paper Products Company, ActiveCare, Jet Midwest Group, and PhaseRx.

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