

Wednesday, May 20, 2020

The COVID-19 Storm and Recession Aftermath

**Weathering the Storm and Cleanup: Bankruptcy,
Foreclosure and Collection**



Bankruptcy, Foreclosure and Collection

What to Expect in 2020

Insights from Historic and Current Data

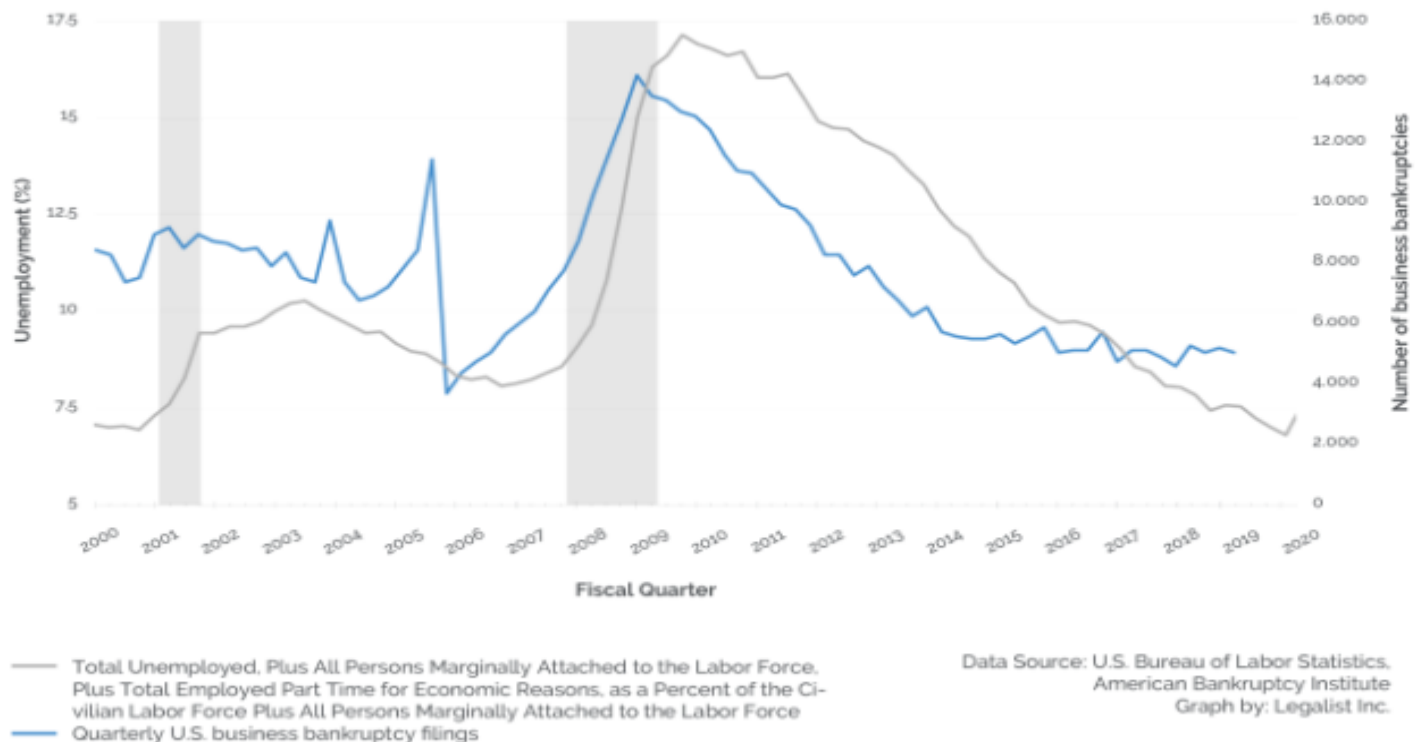
- Bankruptcy filings, and mortgage foreclosures and delinquencies, have historically tracked unemployment rates
 - Consumer bankruptcy filings not likely to be immediate
 - As long as debts are mounting, consumers will wait to file
- Lending has tightened for both business and consumer loans during each of the last three recessions
 - Highly leveraged businesses with good fundamentals will increasingly seek bankruptcy protection
 - The Small Business Reorganization Act of 2019 (SBRA), as temporarily amended by the CARES Act, makes small business Chapter 11 filings economically feasible and attractive
- Service industries (hospitality, tourism, retail, travel and entertainment) are hardest hit now, but . . .
 - Recessions historically spill-over into multiple economic sectors
 - Borrowers dependent upon rental income especially vulnerable to failing retail and restaurant tenants

...And Some Unexpected Differences

- Previous recessions, including the financial crisis of 2008, saw shrinking capital markets and a vast liquidity crunch impacting successful businesses
 - Otherwise viable businesses found themselves without sufficient capital to support operations
- The current crisis involves operational business disruptions and fundamental failures despite strong capital markets
 - Investors seeking distressed-debt opportunities
 - Rescue capital available for viable sectors (possibly excluding retail/restaurant)
 - Government aid remains available on unprecedented scale
- Impending bankruptcy wave likely to be more widespread and over a longer period of uncertainty than previous recessions and recoveries
 - Lack of visibility into future cash flow and other forecasts
 - Impossibility of determining end to health crisis and return to normalcy

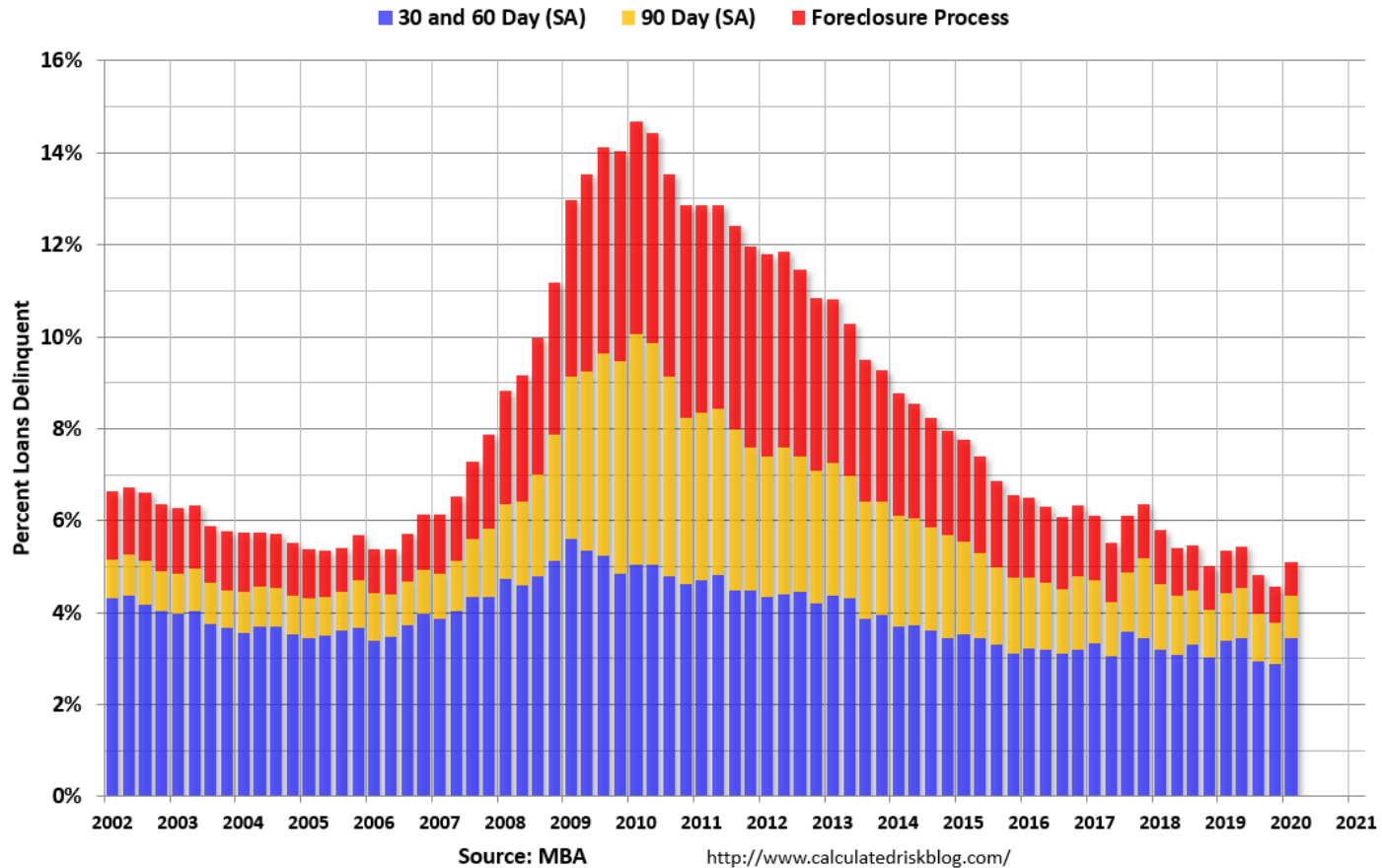
Bankruptcy Filings Historically Track Unemployment Rates

U6 Unemployment Rate vs Quarterly Bankruptcy Filings



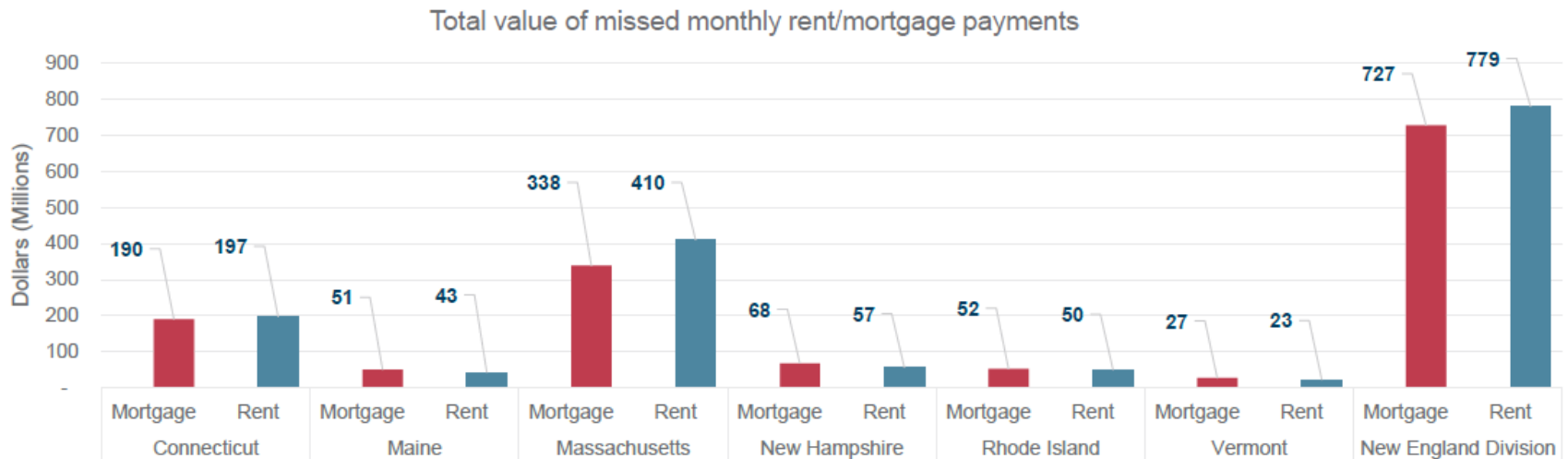
Mortgage Delinquencies and Foreclosures Track Unemployment

Mortgage Delinquencies and Foreclosures by Period Past Due, All Loans



Potential Mortgage and Rent Defaults

The total projected value of missed mortgage and rent payments is more than \$1.5 billion every month in New England alone
Before considering UI expansion and direct payments in the federal CARES Act



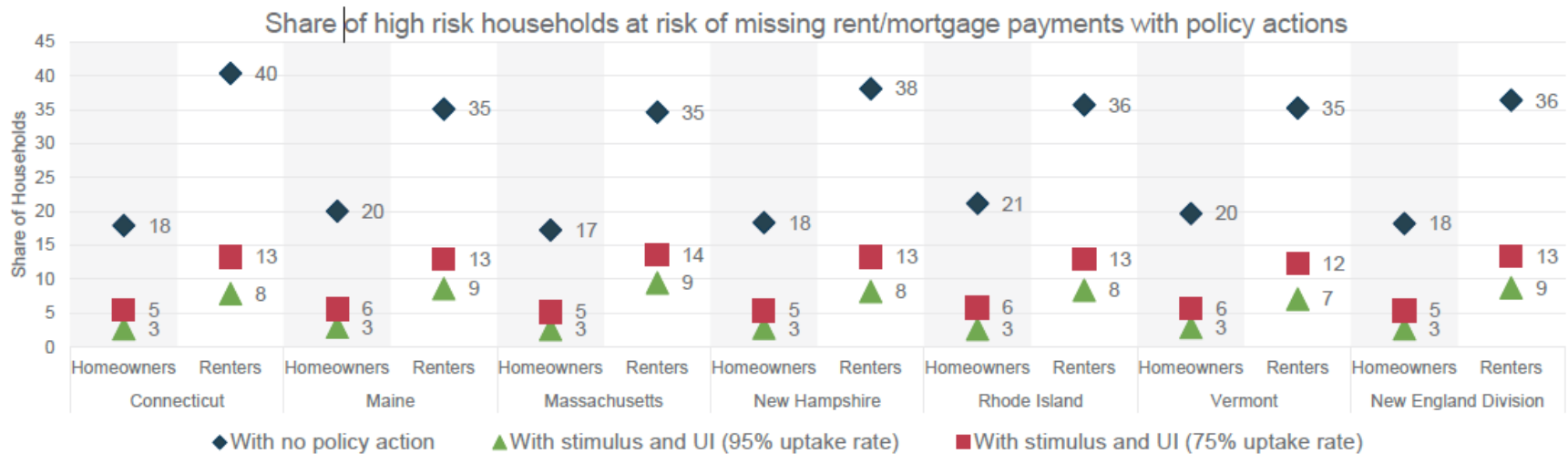
Dollar values are in 2018 dollars. Calculated as the total value of all rent/mortgage payments (including second mortgages) of households who are unable to meet their monthly payment housing cost payments. Households with housing payments are those with a mortgage (including second mortgages) or paying cash rent. High-risk occupations are those defined in Gascon (2020), but with adjustment to include salaried workers who are non-essential and cannot work from home, and to include those non-essential occupations deemed essential based on state policy.

Source(s): 2018 American Community Survey 1-year estimates. USDA Food Plans: Cost of Food Report for December 2018.

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Will Stimulus, UI and Re-Opening Be Enough?

The CARES Act's UI expansion and direct payments to households are likely to have a major impact on households' ability to meet monthly housing payments.



Notes:

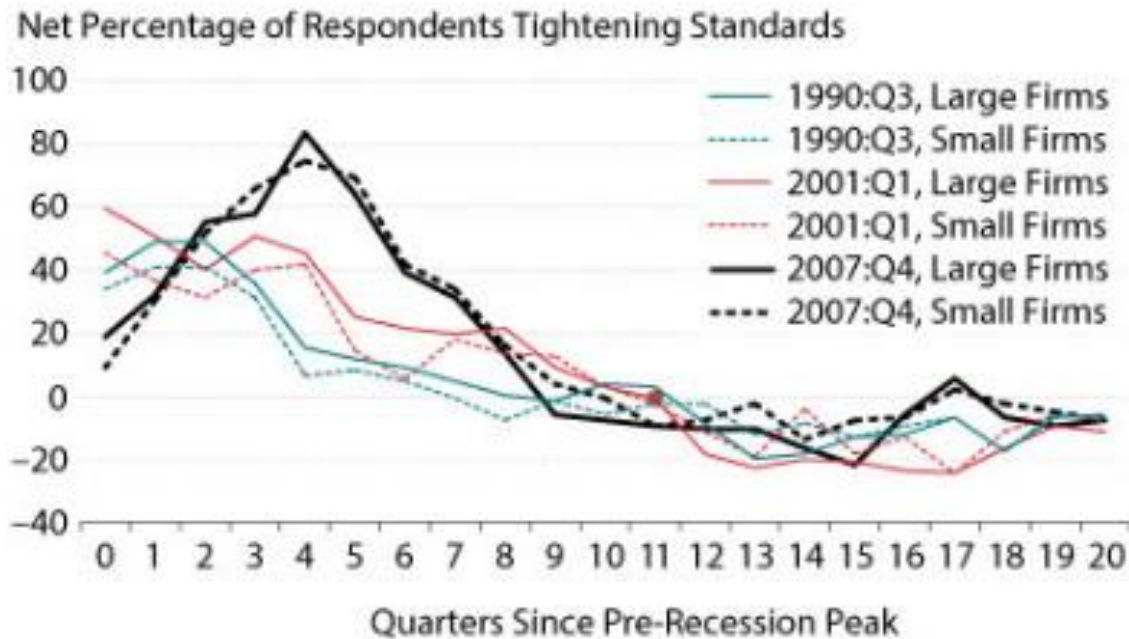
The federal CARES Act provides households with direct payments up to \$1,200 for individuals and \$500 per child, and expands unemployment insurance with a \$600 weekly federal supplement to a broader class of workers. Households are unable to pay their monthly rent or mortgage if their total household income, excluding earnings from high-risk occupations, is less than their monthly housing cost plus a low food budget. Only those households with housing payments such as a mortgage (including second mortgages) and cash rent are included. Given the timing of the CARES Act stimulus payments and our sample period, we are only assigning stimulus payments to those that are likely to have e-filed their taxes (as those people will be given payments first). We assume that one-fourth of direct payments are used to pay housing costs – consistent with budgeting over a four-month period or using the remainder for other household needs. The UI uptake scenarios assume that 75 (or 95) percent of those households that are eligible for UI will apply for benefits. Propensity to e-file varies by adjusted gross income (using IRS data) and propensity to take up UI benefits was assigned randomly across households to low and high take-up scenarios as reflected in past extreme unemployment events (Fuller, Ravikumar, and Zhang (2012)).

Source(s): 2018 American Community Survey 1-year estimates; USDA Food Plans: Cost of Food Report for December 2018; IRS Filing Season Statistics; TAXSIM v9.

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Tightened Credit Will Drive More Businesses to Reorganize

A. Commercial and Industrial Lending Standards



Source: M. Dvorkin and H. Shell, *Bank Lending During Recessions*, Federal Reserve Bank of St. Louis (2016)

Multiply Current Bankruptcy Filings by Three

Mar-02	TOTAL FILINGS	CHAP. 7	CHAP. 11	CHAP. 13	TOTAL BUSINESS FILINGS
ME	1,033	944	1	88	14
MA	4,283	3,502	60	720	128
NH	1,001	891	2	108	49
RI	1,228	1,110	2	116	16
	7,545				

Mar-10	TOTAL FILINGS	CHAP. 7	CHAP. 11	CHAP. 13	TOTAL BUSINESS FILINGS
ME	989	834	6	146	50
MA	5,847	4,522	44	1280	144
NH	1,516	1239	9	268	241
RI	1,398	1,187	14	197	46
	9,750				

Mar-20	TOTAL FILINGS	CHAP. 7	CHAP. 11	CHAP. 13	TOTAL BUSINESS FILINGS
ME	294	232	6	53	20
MA	1,667	1,072	16	575	81
NH	390	302	1	87	16
RI	461	364	1	96	7
	2,812				

Service Industries Hit Hardest So Far

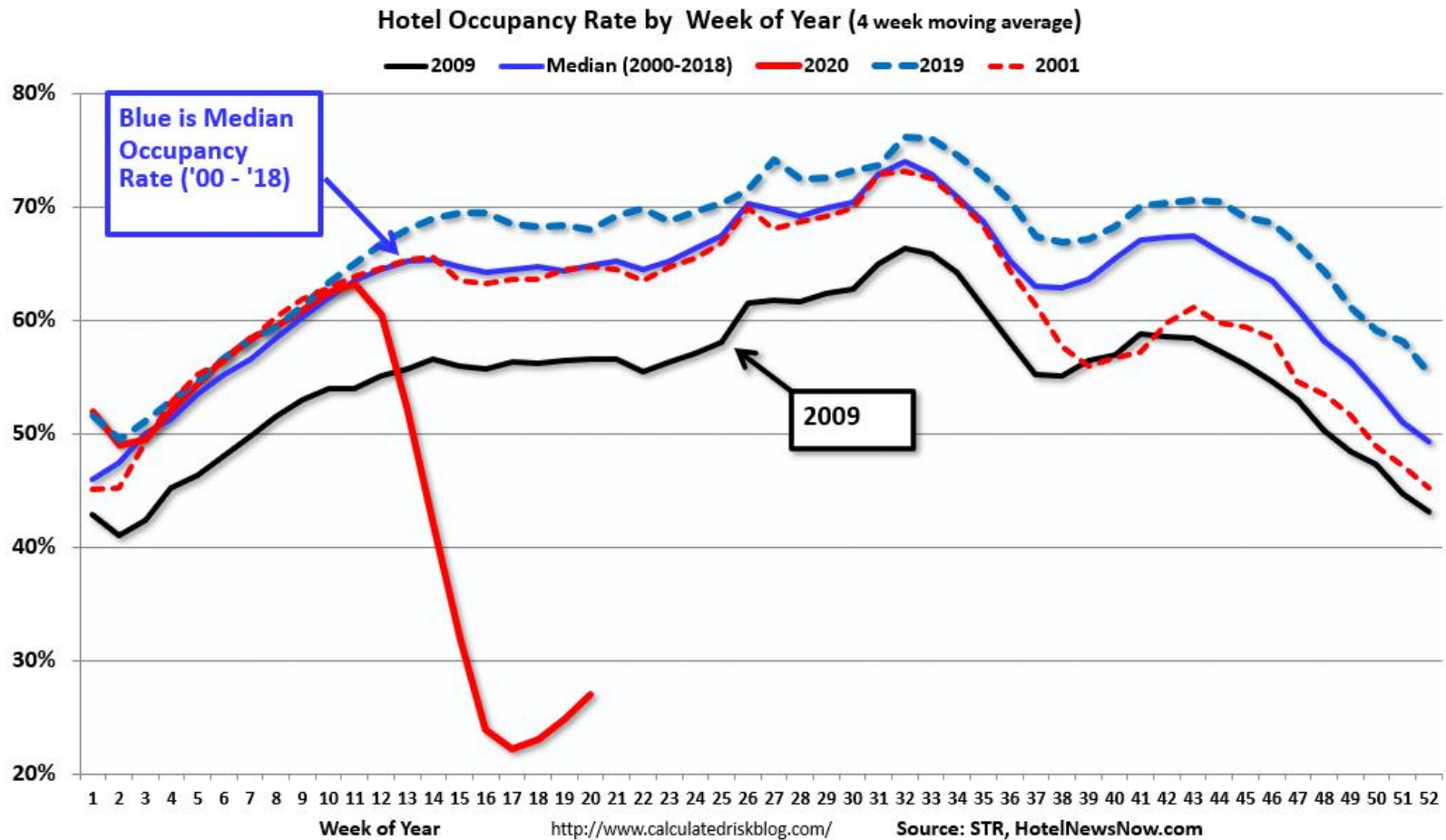
States that report industry-level breakdowns of weekly UI claims show that the majority of initial claims were from the services sector—in contrast to 2009

	Industry Share of Total UI Claims by State					
	Maine		Massachusetts		Vermont	
	March 21 to April 4 2020	March 2009	March 21 to April 4 2020	March 2009	March 21 2020	March 2009
Construction	1.0%	18.8%	8.8%	19.7%	3.0%	28.1%
Manufacturing	5.9%	15.0%	4.5%	12.9%	5.0%	16.9%
Services	36.4%	21.0%	52.8%	36.4%	77.0%	29.2%
Trade	8.4%	10.9%	14.5%	11.9%	5.0%	14.7%
Transportation, Agriculture, and Utilities	1.0%	3.9%	3.7%	3.7%	*	4.3%
Misc/unavailable	47.3%	28.9%	15.5%	11.8%	10.0%	5.4%

*This category is included in misc/unavailable for Vermont.

Sources: Maine Department of Labor, Massachusetts Office of Labor and Workforce Development, Vermont Department of Labor

Is your borrower built to weather the storm?



Recent Chapter 11 Bankruptcy Filings



Neiman Marcus



Pier1



JCPenney

J.CREW

Key Take-Aways

- Be Proactive
 - Where are your material risks?
 - Industries / Borrowers
 - Geography
 - Documentation (including perfection)
 - Collateral type
- Who is built, perhaps with help, to weather the storm?
 - Business fundamentals
 - Capitalization and access to credit
 - Forbearance
 - Workout
 - Amount and composition of trade debt
 - Concentrated or diffuse
 - Active or passive creditors
 - Quality and transparency of principals / management
- Are you internally prepared for the fallout?
 - Adequately staffed and trained
 - Adequate notice and calendar system in place
 - Adequate reserves
 - Declining valuations



Bankruptcy Basics

The Different Chapters of the Code

Types of Bankruptcy Filings

Chapter 7 (Individuals and Businesses)

- Liquidation (company ceases operations and winds down)
- Trustee appointed (company principals no longer in control)
- Discharges all individual's debts unless a statutory exception applies or the court enters a judgment denying the discharge of a debt or all debts

Chapter 13 (Individual Wage Earners Only)

- Simple reorganization for individuals with regular income
- Typically, a five year plan; discharge granted upon completion of plan
- Allows debtor to cure mortgage defaults through plan
- Eligibility based on amount of noncontingent, liquidated secured and unsecured debt

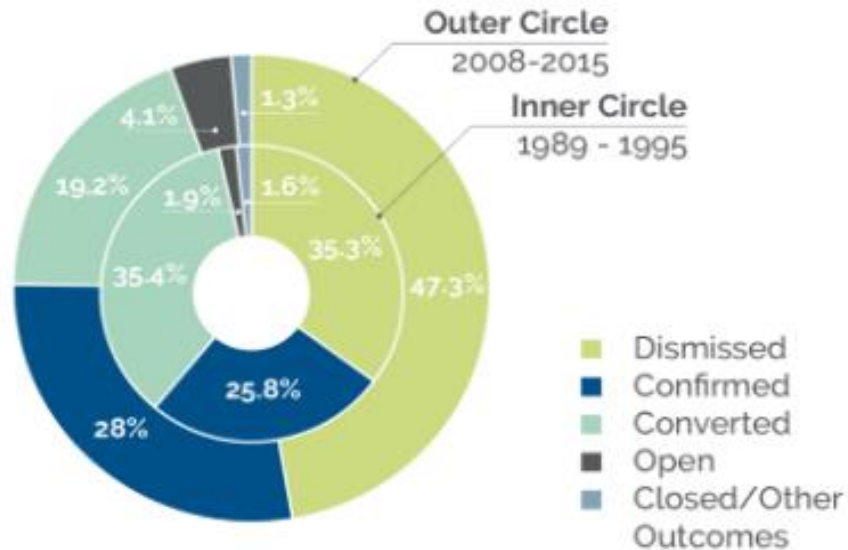
Types of Bankruptcy Filings (continued)

Chapter 11 (Individuals and Businesses)

- Reorganization
 - Gives debtor breathing space to formulate, negotiate and obtain approval of a reorganization plan
 - Broad leeway in what debtor may accomplish through its plan, including determining extent of security and changing amortization, interest rate, and other loan terms
- Debtor remains in control unless the court, for cause, orders otherwise
- Expensive, timely and complicated
- Newly enacted small business reorganization provisions expand scope of relief and reduce expenses for businesses within certain debt limits

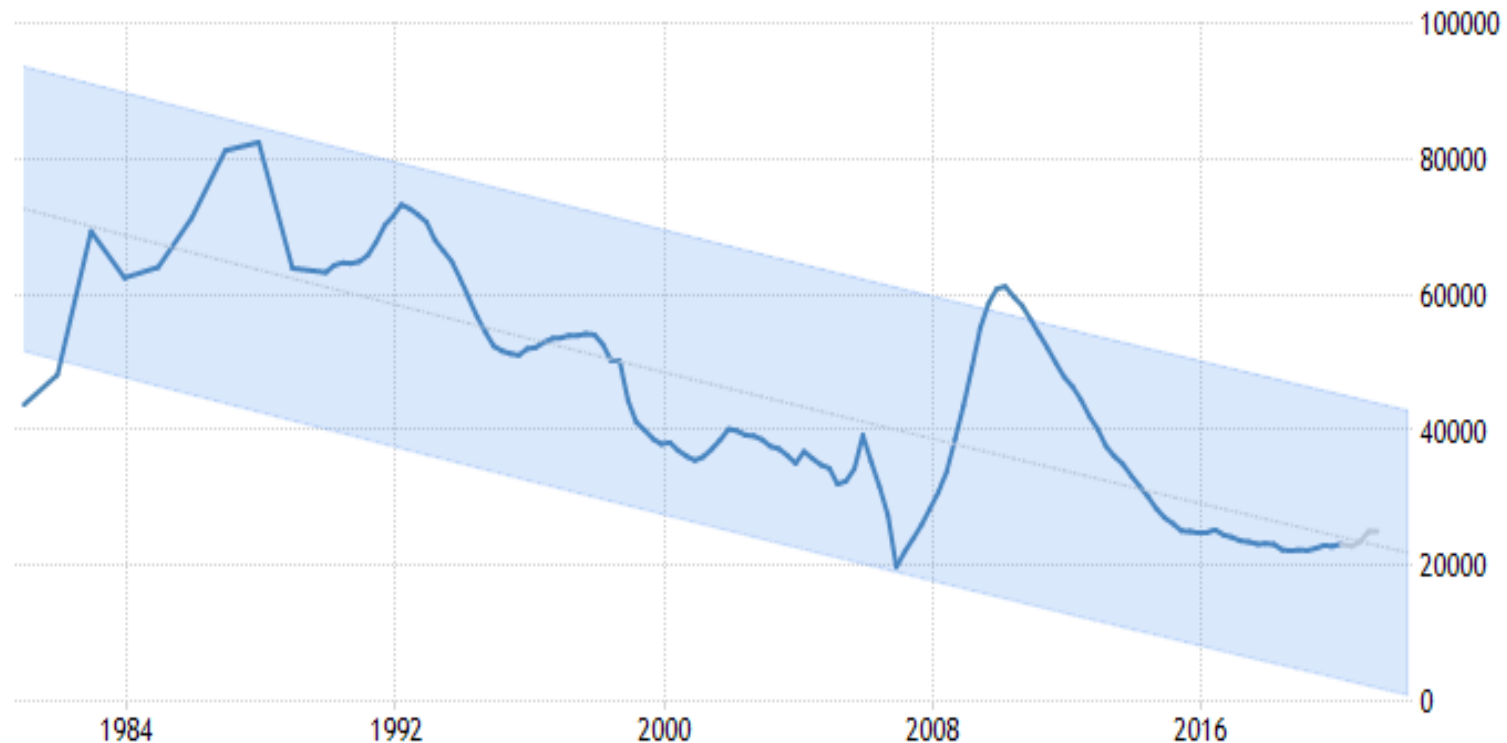
Less Than One-Third of Chapter 11 Debtors Emerge From Chapter 11

Outcomes of Chapter 11 Bankruptcy Cases



Data Source: American Bankruptcy Institute, FICS database
Graph by: Legalist Inc.

Small Business Reorganization Act of 2019: An End to Declining Business Reorganizations?



SOURCE: TRADINGECONOMICS.COM | ADMINISTRATIVE OFFICE OF THE U.S. COURTS

Small Business Reorganization Act of 2019

- Became effective February 20, 2020
- Created new Subchapter V of Chapter 11
- Eligibility
 - Available to both individual and corporate borrowers
 - Must be engaged in “commercial or business activity” (but may also have consumer debts so long as they are less than 50%)
 - \$7,500,000 debt limit (which will revert to \$2,725,625 in one year unless further extended by Congress) for combined secured and unsecured debts
 - No “single-asset real estate” debtors

SBRA (continued)

- Key differences from traditional Chapter 11:
 - Small Business Trustee appointed in every case
 - No creditors' committees
 - No quarterly fees payable to the US Trustee
 - Simple, efficient, quick and cost-effective plan of reorganization process:
 - Exclusive to debtor (no competing Chapter 11 plans)
 - 90-day plan deadline
 - No separate disclosure statement required
 - Modification of mortgage on principal residence possible
 - No acceptance of impaired class required to confirm over objection of creditors
 - Allows debtor to stretch out payment of administrative expenses over the term of the Chapter 11 plan



Receiverships

A Secured Creditor Option and
Bankruptcy Alternative

Traditional Rhode Island Receivership

- Initiated by borrower or secured creditor
- Can be more economical
- Parties have a say/ability to recommend choice of receiver
- Not code driven
- Receiver has ability to operate business while liquidating assets
- Secured creditor has say in how matter proceeds and assets are liquidated
- Sale authorized by court order(s)

New Rhode Island Non-Liquidating Receivership

- Created via Administrative Order of Presiding Justice for Rhode Island Superior Court in response to COVID-19 and new small business Chapter 11 bankruptcy provisions
- For businesses that were solvent and meeting debts in the ordinary course prior to pandemic shut down
- Allows business owners, with assistance of court and receiver, to develop a reorganization plan
- Owner stays in control with receiver oversight/assistance
- Goal is to emerge with viable business



Bankruptcy Essentials

The Bankruptcy Distribution Waterfall

- Secured claims
- Administrative expenses
 - Super-priority
 - All others
- Priority unsecured claims—e.g.:
 - Tax Claims
 - Unpaid wages
- Unsecured claims—e.g.:
 - Trade claims
 - Deficiency claims
- Equity

The Automatic Stay

- Arises as soon as case is filed
- Operates to prevent any collection action against debtor or foreclosure action against property of the estate, including loan collateral
- **Does not stay action against guarantors or co-borrowers**
- **Does not stay pursuit of letter-of-credit rights**
- Relief from stay possible for cause, with Courts considering factors such as:
 - Nonpayment or other default
 - Equity cushion
 - “Adequate protection” payments
 - Realistic likelihood of reorganization
- Pre-bankruptcy waivers may be difficult to enforce

Adequate Protection

- Not defined by the Bankruptcy Code
- Intended to protect lender from diminution in value of collateral
 - Priming liens of taxing authorities, condominium associations, etc.
 - Insurance to prevent loss or liability related to collateral
 - Depreciation of equipment or other wasting assets
 - Court likely to order interim monthly payments only to compensate for anticipated loss, not full monthly payments under loan agreement

Cash Collateral

- What is Cash Collateral?
 - Cash, rents, receivables, proceeds, etc.
 - May not be (but often is) used absent Court approval or lender consent
 - Maintain control of cash collateral
 - Use lockbox, bank account control agreement, dual-payee checks, etc.
- Use of Cash Collateral
 - Requires Court approval
 - Subject to terms of cash collateral agreement
 - Budget to limit use
 - Segregated account
 - Adequate Protection
 - rollover lien

Important Early Bankruptcy Events

- **Petition for Relief**

- Bankruptcy petition, whether voluntarily or involuntarily filed, triggers automatic stay of all acts against the debtor and property of the debtor
 - Collection actions, including foreclosures, must stop immediately
 - Dunning must cease

- **Notice of Filing**

- Provided to all creditors, includes date of creditors' meeting and deadline for filing claims and objecting to individual debtor's discharge and dischargeability of a debt

- **First Day Motions Hearing (Chapter 11 Cases)**

- Debtor-in-Possession financing (DIP financing)
- Use of cash collateral

Important Early Bankruptcy Events (continued)

- **Section 341 Meeting of Creditors**

- Initial meeting with United States Trustee and creditors concerning debtor's case

- **Claims Bar Date**

- Deadline to file claims against debtor
- Beware of separate deadlines for specific claims
 - Reclamation claims for goods sold and delivered within 20 days of bankruptcy filing
 - Administrative expense claims (including secured lender's legal fees charged to borrower)



The Secured Lender in Chapter 11

Its Right to be Paid

Chapter 11 Plan Process

- Debtor has exclusive right to propose plan for 120 days (extendible), after which other parties in interest may propose plan
- Classification of claims: Similarly situated claims classified together
 - Each secured claim in its own class
 - All unsecured claims in a single class
- Voting
 - Unimpaired claims deemed to accept
 - Claims receiving no treatment deemed to reject
 - To confirm a plan, debtor must obtain acceptance of at least one impaired class of claims:
 - Two-thirds in dollar amount of voting claims
 - One-half in number of voting claims

Treatment of Secured Claims

- Cramdown: plan may be confirmed over rejection or objection by secured creditor so long as debtor obtains vote of at least one impaired class
- “Indubitable equivalent”: debtor must provide present value of lender’s lien as of petition date, but may alter:
 - Term
 - Interest rate
 - Value of collateral—debtor may strip lien down to value of collateral if lender is undersecured
- Interest, late fees, attorneys’ fees, and other costs
 - Oversecured lenders entitled to collect
 - Undersecured lenders not entitled to collect
- Deficiency claims are entitled to treatment as unsecured claims



Foreclosure and Eviction

Foreclosure Moratoriums

- CARES Act Federal
 - The CARES Act provides that a federally backed mortgage loan borrower who affirms he or she is experiencing financial hardship due directly or indirectly to the COVID-19 emergency shall be granted a forbearance of up to 360 days
- Maine
 - Subject to limited exceptions, no evictions until 30 days after the termination of the COVID-19 state of emergency
 - Unless otherwise ordered by the court, no foreclosure proceedings scheduled or heard through remainder of May 2020; extension of order is possible but not yet determined

Foreclosure Moratoriums (continued)

- Massachusetts
 - Temporary moratorium on all non-essential evictions against:
 - Residential
 - “small business premises unit”
 - Not multistate or multinational
 - Not publicly traded
 - Fewer than 150 employees
 - “Non-essential” includes evictions based on
 - Foreclosure
 - Non-payment of rent
 - Expiration on sooner of:
 - August 18, 2020; or
 - 45 days after emergency declaration lifted

Foreclosure Moratorium (continued)

- New Hampshire
 - No evictions or foreclosures during state of emergency by Governor's order
- Rhode Island
 - Voluntary agreement by lenders on April 24, 2020
 - 60-day foreclosure moratorium
 - 90-day forbearance
 - No late fees and other charges



Questions?

The information within this presentation may not account for all specifics of your particular situation. It is not confidential legal advice and does not create an attorney-client relationship. Responsive inquiries are also not confidential and do not create an attorney-client relationship. You should always consult a legal professional to determine how the law may apply in your specific circumstances. We welcome the opportunity to discuss providing you with legal advice pursuant to a mutually agreeable written retainer agreement.

Presenters

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