

SURVIVING CHAPTER 11 BUSINESS BANKRUPTCY DURING COVID-19

By: Sahrish K. Soleja

The coronavirus pandemic has indiscriminately affected various sectors of the United States economy in a short span of time—including the legal profession. In an early effort to prevent a pandemic-led economic depression the Federal Reserve cut the federal funds rate to nearly zero.¹ Furthermore, the federal government has passed three stimulus packages, with the most recent \$2.2 trillion stimulus package passed on March 27, 2020.² Notwithstanding the government's efforts the unemployment rate rose to 14.7% in April 2020.³

With major retailers like J. Crew⁴ and Neiman Marcus⁵ leading the way, bankruptcy filings are predicted to increase. Cash-strapped businesses that are considering filing for bankruptcy to reorganize may be faced with the challenge of obtaining financing to fund a plan of reorganization. Hence, to successfully emerge from a Chapter 11 bankruptcy it is vital to obtain financing.

Although large banks have not seen a wave of loans go bad, some banks have set aside provisions to cover potentially bad loans to ride out the pandemic-led recession.

- JPMorgan Chase & Co. set aside \$6.8 billion in the first quarter of 2020, largely in its consumer division;⁶
- WellsFargo & Co. set aside \$3.83 billion in the first quarter, in both the consumer and commercial divisions;⁷ and
- Bank of America set aside \$4.76 billion.⁸

Still, both JPMorgan and WellsFargo reported a 6% increase in corporate lending in the first quarter of 2020.⁹

Chapter 11 of the Bankruptcy Code allows the debtor an opportunity to reorganize its business while maintaining control of business operations (“**Debtor in Possession**”).¹⁰ A Chapter 11 bankruptcy may also be filed to conduct an orderly liquidation of the debtor's estate or merely

to sell the business as a going concern. A Debtor in Possession needs cash to operate throughout the bankruptcy. Without adequate cash flow the Debtor in Possession risks conversion of the bankruptcy case from a Chapter 11 to a Chapter 7 liquidation.

Section 364 of the Bankruptcy Code is designed to encourage lenders to provide Debtor in Possession financing (“**DIP Financing**”).¹¹ Lenders who provide DIP Financing are provided favorable treatment in the bankruptcy process.¹² There following four variations of DIP Financing are available to a Debtor in Possession under Chapter 11:

- Unsecured financing with superpriority claim;¹³
- Financing secured by liens on unencumbered assets;
- Financing secured by junior liens on encumbered assets; and
- Financing secured by senior or equal liens on assets.¹⁴

First, a lender may provide unsecured financing with superpriority claim allowing it to be paid before all of the other administrative claims.¹⁵ Second, a lender may provide financing secured by a lien on unencumbered assets.¹⁶ Third, a lender may provide financing secured by a junior lien on encumbered assets subject to existing liens.¹⁷ Finally, a lender may provide financing secured by a priming lien subject to existing liens.¹⁸ A Debtor in Possession may be able to obtain one form of DIP Financing listed above, or a combination of the variations.

Obtaining post-petition DIP Financing serves several purposes – it allows the Debtor in Possession to continue its operations, restore confidence in its employees and customers, and continue to work with its vendors. More importantly, post-petition DIP Financing allows the Debtor in Possession to focus on its reorganization efforts to emerge successfully from bankruptcy.

In direct response to the federal government’s actions, several small and large banks are approving loans to businesses under the Payment Protection Plan (“**PPP**”).¹⁹ Although obtaining

post-petition financing under the PPP is currently a topic of debate²⁰, it may be beneficial for a business to obtain a loan under the PPP prior to commencing a bankruptcy case.

All eyes are on the United States as it slowly reopens its economy. The big question is, what happens when the PPP funds run out? Will banks be as eager to approve business loans? As the economic landscape continues to develop in response to the coronavirus, it falls upon legal professionals to assist their clients in obtaining financing opportunities. Furthermore, the bankruptcy practice will need to address novel issues that arise as a result of these unique circumstances.

¹ Heather Long, *Federal Reserve slashes interest rates to zero as part of wide-ranging emergency intervention*, THE WASHINGTON POST, March 15, 2020, <https://www.washingtonpost.com/business/2020/03/15/federal-reserve-slashes-interest-rates-zero-part-wide-ranging-emergency-intervention/>.

² Siobhan Hughes & Natalie Andrews, *Trump Signs \$2 Trillion Coronavirus Stimulus Bill After Swift Passage by House*, THE WALL STREET JOURNAL, March 27, 2020, <https://www.wsj.com/articles/house-lawmakers-race-to-washington-to-ensure-coronavirus-stimulus-passes-11585318472>.

³ Sarah Chaney & Eric Morath, *April Unemployment Rate Rose to a Record 14.7%*, THE WALL STREET JOURNAL, May 8, 2020, <https://www.wsj.com/articles/house-lawmakers-race-to-washington-to-ensure-coronavirus-stimulus-passes-11585318472>.

⁴ Soma Biswas & Suzanne Kapner, *J.Crew Tumbles Into Bankruptcy in the Wake of Coronavirus*, THE WALL STREET JOURNAL, May 4, 2020, <https://www.wsj.com/articles/j-crew-files-for-bankruptcy-protection-reaches-debt-swap-deal-11588583196?mod=searchresults&page=1&pos=19>.

⁵ Suzanne Kapner & Soma Biswas, *Neiman Marcus, the Retailer to the Rich, Files for Bankruptcy*, THE WALL STREET JOURNAL, May 7, 2020, <https://www.wsj.com/articles/neiman-marcus-the-retailer-to-the-rich-stumbles-into-bankruptcy-11588860617?mod=searchresults&page=1&pos=10>.

⁶ David Benoit & Ben Eisen, *JPMorgan, Wells Fargo Profits Tumble as Banks Brace for a Recession*, THE WALL STREET JOURNAL, April 14, 2020, https://www.wsj.com/articles/jpmorgan-wells-fargo-profits-tumble-as...ace-for-a-recession-11586881571?mod=hp_lead_pos2&mod=article_inline.

⁷ *Id.*

⁸ Ben Eisen, *Bank of America Profit Falls 45% as It Prepares for Loan Defaults*, THE WALL STREET JOURNAL, April 15, 2020, <https://www.wsj.com/articles/bank-of-america-reports-first-quarter-profit-fell-45-11586948606>.

⁹ David Benoit & Ben Eisen, *JPMorgan, Wells Fargo Profits Tumble as Banks Brace for a Recession*, THE WALL STREET JOURNAL, April 14, 2020, https://www.wsj.com/articles/jpmorgan-wells-fargo-profits-tumble-as...ace-for-a-recession-11586881571?mod=hp_lead_pos2&mod=article_inline.

¹⁰ 11 U.S.C. §§ 1101(1), 1107, and 1108.

¹¹ 11 U.S.C. §364.

¹² *Id.*

¹³ 11 U.S.C. §364(b).

¹⁴ 11 U.S.C. §364(c).

¹⁵ 11 U.S.C. §364(b).

¹⁶ 11 U.S.C. §364(c)(2).

¹⁷ 11 U.S.C. §364(c)(3).

¹⁸ 11 U.S.C. §364(c)(1).

¹⁹ Jeanna Smialek & Emily Flitter, *Federal Reserve Moves to Pump Up Small Business Lending During Coronavirus Pandemic*, THE NEW YORK TIMES, April 6, 2020,

<https://www.nytimes.com/2020/04/06/business/economy/federal-reserve-small-business-loans.html>; Peter Rudegeair, Orla McCaffrey & Liz Hoffman, *Small Businesses Were at a Breaking Point. Small Banks came to the Rescue.*, THE WALL STREET JOURNAL, May 4, 2020, <https://www.wsj.com/articles/small-businesses-were-at-a-breaking-point-small-banks-came-to-the-rescue-11588590013>.

²⁰ See *Hidalgo Cnty. Emergency Serv. Found. v. Carranza*, 2020 WL 2029252, 2020 Bankr. LEXIS 1174 (Bankr. S.D. Tex. April 25, 2020) (J. Jones granting a preliminary injunction against the Small Business Administration holding that Plaintiff is authorized to submit a loan application under the PPP), *contra Cosi, Inc. v. The U.S. Small Business Administration, et al.*, 20-50591-BLS-11, Doc. No. 15 (Bankr. Del. Apr. 30, 2020) (denying request for preliminary injunction against the Small Business Administration).