Preparing for the economic fallout from the coronavirus

Marc J. Carmel | Friday, March 20, 2020

Executives around the country are focused on the immediate impact of the coronavirus on their employees, customers, suppliers, and others with whom they do business. That is to be expected. It is also not surprising that the drastic restrictions on travel and social interaction have occupied folks around the world.

If executives are only focused on the near term, however, they will not be prepared for the next challenge they will confront, which is the economic distress that is looming. The coronavirus and the associated slowdown from quarantines, shelters in place, and related responses—all sensible—will challenge the global expansion that has lasted more than a decade, particularly when coupled with the tremors caused by the sudden drop of the price of oil.

While history may not repeat itself, it often rhymes, and lessons learned from being a restructuring attorney through several economic downturns provide relevant guidance here.

Cash is king

In a financially stressful situation, “cash is king.” This is important in several respects. Companies should be focused on ensuring that they have access to cash. A business cannot pay its employees, suppliers, or vendors in revenue numbers, adjusted EBITDA, or hope certificates. Therefore, executives must make sure that they have access to cash. Companies should seriously consider drawing down on revolving lines of credit and delayed draw term loans and increasing credit lines, where possible.

This is important to do sooner rather than later (and maybe immediately) because tapping credit likely requires satisfying conditions to borrowing under loan documents, which may mean: bringing down (i.e., being able to satisfy as of the time of the draw) representations and warranties; satisfying covenants and notice requirements; and proceeding only if there are no defaults or events of default. Lenders likely will evaluate the business and scrutinize the loan documents to determine whether it needs to satisfy the draw down, including any limitations in the documents on the use of proceeds and anti-hoarding provisions. Their initial response may not be the final answer, and executives should be prepared to make the case for why an extension of credit is in the lenders' best interest.

Even if a company does not need to access liquidity immediately, it should consider whether borrowing will be available in the future when it is needed. Where a company's performance may deteriorate over time or where its covenants tighten in future periods, drawing down later may become more difficult (or impossible).

Additionally, companies want to make sure that they gain access to money before banks freeze up in the event of a credit crunch. With interest rates as low as they are now, the cost of drawing on a revolver and getting the "insurance policy" of additional liquidity comes with a relatively low cost.

Companies need to have a good understanding of their cash position now and in the future. It is critically important for companies to prepare cash flow projections and an updated business plan. These must be realistic and take into account the situation that the business will confront and be flexible to respond to changes in circumstances. While historical reporting will be a helpful guide, thoughtful considerations about revenue and expenses, cash receipts and disbursements, and the direction of the business in light of the changed circumstances will be crucial. This cash flow budget and updated business plan will help a company understand its needs and help lenders and other key constituents assess the situation if the company needs to have serious, difficult conversations.

Having available cash is beneficial to operate the business in the near term, to address unforeseen issues that may arise, and to enable the company to capitalize on a good opportunity from a liquidity-starved company in the future.

Also keep in mind that lenders are going to be juggling a lot of distressed credits. Whatever a company may be planning, it should not wait until its situation is dire before reaching out to its lenders, because they otherwise may be too busy to respond in time.

Maintain appropriate lines of communication

In stressful situations, communication is incredibly important. In some circumstances, this means open lines of communication, even when the message may be disconcerting to the audience. In some cases, this means carefully controlled communication to avoid aggravating a problem. In any event, a company's messaging to executives, customers, employees, suppliers, financing sources, and other stakeholders requires careful planning and delivery.

Make sure directors and officers follow appropriate processes

Directors and officers of a company are subject to obligations to act in the best interest of the company and on an informed basis after considering all relevant, available information and deliberating among themselves and with advisors. These so-called "fiduciary duties" are based on the laws of the state in which the company is organized. The exigencies of the current situation should not convince directors and officers to disregard these duties. At the same time, these duties are often satisfied—minimizing or eliminating liability—if the directors and officers follow a proper process.

Review director and officer liability insurance policies

Companies frequently ask their regular insurance broker to help them secure insurance to protect directors and officers from liability (D&O insurance). But D&O insurance requires an expert because it is a specialized product, and policy language varies widely. The D&O insurance "fine print" often contains exclusions and exceptions that result in directors and officers not being able to collect from the policies. This is particularly important because directors and officers rely on D&O insurance coverage to protect against significant economic exposure and the situations where D&O insurance is relevant is often when the company is financially distressed and unable to protect the directors and officers if the insurance is not available. Needless to say, now is a great time to have a D&O insurance specialist review policies to identify coverage gaps and work to fix them with an amendment or a replacement policy.

Make sure to review key relationships

I have heard and read the term "force majeure" more times in the past few weeks than I had in the previous 20 years. It describes a contractual provision that allows one party to a contract to suspend or stop performing their contractual obligations when certain circumstances beyond a party's control arise and prevent it from performing. There may be situations in which the coronavirus and the related government responses trigger force majeure provisions and relieve a party from having to perform without facing liability from breaching its obligations.

This is one example of how a contract provision could affect a contractual relationship. There are other contract provisions that may allow contract counterparties to change the relationship going forward in terms of duties to perform, breaches and defaults, and notice requirements. Some other examples are provisions that affect rights if there is a "material adverse change" or "material adverse effect." In addition to contractual rights, companies should consider common law rights and statutory rights, including lien rights and rights and remedies under the Uniform Commercial Code.

The question of whether contractual provisions can be enforced in beneficial or detrimental ways cannot be considered in a vacuum. The answer requires a careful review of relevant contracts, applicable law, and the facts of the situation. As a result, companies must engage in a thoughtful approach to determine how they may be affected. Even if litigation may yield a favorable answer, negotiated resolutions typically lead to more efficient solutions that preserve important relationships.

How contractual and legal rights allocate liability addresses whether a party is entitled to damages, it does not fix supply change disruptions and will not determine how a business will operate under the changing circumstances that businesses encounter. Executives should inventory and examine their key relationships to ensure that their business can continue to operate. This exercise will allow a business to respond quickly to remedy issues with key constituents and may uncover other value maximizing opportunities.

Manage contractual relationships rather than proceeding with business as usual

Companies should pay special attention to contracts that come up for renewal or have provisions that allow for termination. This may be the right time to consider whether a company wants to be committed with a supplier or customer long term, especially if the supplier or customer may end up in bankruptcy during the term of the agreement. Or it may be a good opportunity to negotiate for better payment terms (even considering cash in advance), other economic and non-economic terms, and credit support in the form of guaranties from credit worthy entities, pledges of collateral, letters of credit, or something similar.

When a supplier allows its customers to pay for goods and services days, weeks, or months after the goods and services are provided, the customers are “borrowing” and the supplier is “extending credit.” As payment terms loosen and as additional receivables are generated, the supplier ends up waiting a longer period of time to receive its payment (which itself has a cost) and is at risk of non-payment for higher amounts from a customer that may not have the financial wherewithal to pay its debts. A customer that has trouble satisfying its receivables timely is unintentionally telling its supplier that it’s distressed, and the supplier should be “listening” for this.

A company should also be aware that as payment terms begin to fluctuate from normal or “ordinary course,” it is increasing its risk of receiving a “preference.” In this context, a preference is a payment a company receives from a customer during the 90 days immediately before the customer enters bankruptcy. In certain circumstances, the customer may be able to file a lawsuit and “claw back” the payment, and the company may be responsible for returning the payment. To avoid this, the company should manage its receivables carefully.

Be prepared to be opportunistic while remaining disciplined

Warren Buffett, Chairman of the Board of Berkshire Hathaway and noted investor, is famous for saying: “Be fearful when others are greedy, and be greedy only when others are fearful.” There will be opportunities to buy distressed business and assets. With Mr. Buffett’s suggestion, it is also helpful to keep in mind that it’s dangerous to “try to catch a falling knife.” Instead, potential buyers should wait for the market to stabilize.

These aphorisms are generally good advice but insufficient to ensure that pursuing new businesses or assets will be good investments. With businesses suffering significant impairment from the current situation, tight liquidity, and general uncertainty, there will be many opportunities to purchase businesses and assets at prices that are far lower than they were in recent history. Executives that have stabilized their own business and have access to capital will be well-positioned to take advantage of the opportunities.

Of course, buying distressed businesses and assets involves risks, including risks that the distress is more significant than expected as well as risks that creditors whose claims remain unpaid will look to the purchaser to satisfy those claims. Executives that are looking to invest in distressed assets and businesses should proceed with careful planning and execution to minimize these risks.

Consider compensation structures to incentivize and reward properly and other employee issues

Most companies developed their current compensation structures based on a set of criteria that likely is not relevant in light of what the companies are going to face in the near future. As a result, those structures may not provide the proper amount and form of compensation or mechanisms to incentive executives and other employees in a way that align with the interests of the company going forward. Executives should reevaluate the compensation structure for their executives and non-executives, while being mindful of how this will be perceived by other constituents.

As it relates to employees, the legal landscape is changing in real time. As executives consider right-sizing their workforce, they should be mindful of how a company’s actions can affect their business and their workforce. There may be meaningful differences to employers and employees as a result of how decisions are effectuated. For example, furloughs and layoffs may appear similar but lead to very different results. Executives should address employee issues thoughtfully.

Do not lose sight of reporting requirements

Companies are facing two distinct challenges as it relates to reporting requirements. First, the current situation will impact what they need to report. Almost every business is affected by the coronavirus in significant ways. This will lead to complex disclosure issues, especially for businesses that have disclosure requirements imposed by the government.

Second, the restrictions that are forcing people to avoid meeting in offices and instead requiring that they work from home will make it more difficult for businesses to prepare the disclosures necessary to satisfy their reporting requirements.

Failing to satisfy reporting requirements timely could have a number of implications, including: defaults under financing arrangements that may prevent a company from accessing capital or even accelerate loans; defaults under contractual arrangements; corresponding cross-defaults; and regulatory issues. Businesses need to devise a plan to satisfy reporting requirements. It would be challenging to compile the necessary financial and other information and address the new disclosure that will be necessary under the best circumstances, and personnel and advisors working from home will exacerbate these challenges.

Insurance coverage may (or may not) be available

As companies consider the impact of the coronavirus on their business, they should consider whether they may have insurance for losses. Depending on their insurance coverage and the specific facts, it's possible that losses that the business sustains are covered by business interruption or similar insurance or that liability insurance may apply where the business is liable to a third party. With all insurance matters, the devil is in the details.

The situation that we are facing is unique, and there's no off the shelf play book for how to respond. But some themes are consistent across economic downturns: identify concerns as soon as possible; be disciplined in assessing the situation; consider all reasonable alternatives; communicate properly with stakeholders; respond appropriately; and reconsider the situation if and when relevant facts change. All of this is easier to do with the assistance of advisors who have been through this before.

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