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A Perfect Financial Stress Storm: A Q&A With Dorsey & Whitney's Joseph Acosta

Texas Lawyer spoke with Dorsey & Whitney partner Joseph Acosta about the financial health of many big-name oil and gas, retail, restaurants and travel companies.

BY KENNETH ARTZ

Joseph Acosta is a partner at Dorsey & Whitney's Dallas office. During his 21-plus years as a lawyer, he has been involved in some of the largest and most complex restructurings, Chapter 11 bankruptcies, and litigation projects in the United States.

Texas Lawyer spoke with him recently about the financial health of many big-name oil and gas, retail, restaurants and travel companies.

The COVID-19 pandemic has been a perfect storm, exacerbating problems for companies, including Chesapeake Energy, which filed bankruptcy last week, and J.C. Penney, which filed bankruptcy last month. Both had faced struggles for several years, and now other well-known corporations are on the brink. How did this happen and what's next?

Joseph Acosta: What is happening is that there are numerous companies in the energy, retail, restaurant and travel sectors that are in financial distress on account of the COVID-19 pandemic, which resulted in the unprecedented shutdown of the retail economy nationwide. A substantial reduction in demand for consumables as well as retail foot traffic, caused by government shelter-in-place orders, have led to much lower commodities pricing in the case of energy and a virtual halt in revenues in the case of retail, restaurants and travel. At the same time, as unemployment has skyrocketed to historic levels (reaching over 13% nationwide in April), outputs in the

Joseph Acosta, partner at Dorsey & Whitney.

manufacturing and service sectors have suffered substantially, especially in Texas. According to a report by the Federal Reserve Bank of Dallas last month, these are key metrics for Texas, the second largest economy in the U.S., next to California. Indeed, the service industry comprises 70% of Texas' private-sector outputs, Texas produces 10% of U.S. manufactured goods, and Texas is the No. 1 producer of oil and gas in the nation.

For the companies that were already struggling, like Chesapeake and J.C. Penney, the pandemic was the straw that broke the camel's back. But, they were not the only ones. According to the American Bankruptcy Institute, commercial Chapter 11 filings from January to June 2020 increased 26% to 3,604 from the 2,855 filings during the same time period last year. Rystad Energy, an independent research and analytics company, even predicts that there could be up to 73 and 170 upstream oil and gas company filings this year and next year, if West Texas Intermediate (WTI) remains constant at $30/barrel.

On the retail sector, we are seeing giant company filings every day, including those of Brooks Brothers, Lucky Brands, Muji U.S.C., J. Crew, J.C. Penney, Neiman Marcus, Container Store and GNC,, to name a few. Then, there are those retailers, like Bed Bath & Beyond, that recently announced sales tumbling nearly 50% and massive store closings in the near future. Everyone who has had to cancel their business trips and vacation plans is also aware that the travel industry is hemorrhaging right now.

The largest bankruptcy filing this year was that of Hertz Corp., a $25 billion company, and this filing was solely attributable to the challenges in this industry. As for the airline industry, the International Air Transport Association (IATA) recorded losses by airlines in all markets except China, which bottomed out in February. The $84 billion in expected losses for all of 2020 would mark the worst financial result in aviation history. Several airlines have already entered bankruptcy protection or administration since the start of the pandemic, including Aeromexico, Air Mauritius, Avianca, South Africa's Comair, LATAM Airlines, Thai Airways and Virgin Australia. These were due to lack of government assistance.

As for restaurants, we are seeing filings and announcements on a weekly basis, most notably the latest ones of Chuck E. Cheese, a Dallas-based chain, and Fig & Olive, a New York-based chain. The Independent Restaurant Coalition further estimates that 85% of the country's independent restaurants will close by the end of 2021 due to the disruption caused by the pandemic. Every restaurant is fighting to survive with reduced seats, reduced sales, and less staff.

But, it is not likely that we have seen the bottom yet, as the government assistance programs, like the CARES Act, PPP and main street lending, are fading away during the second half of 2020. The upcoming financial reporting for the second quarter of 2020 will likely provide a better picture of the magnitude of what we are dealing with across these various sectors of the economy.

What's it all mean for bankruptcy attorneys and corporations drowning in debt?

We have to distinguish between business bankruptcy or restructuring attorneys, which deal with commercial bankruptcies or Chapter 11s, and consumer bankruptcy attorneys, which handle consumer cases, like Chapters 7 and 13. With respect to the former, the activity level has picked up substantially, as restructuring attorneys have been busy advising businesses, lenders, landlords and other constituents how best to handle their distressed debt situations. Most of the times, good restructuring counsel can avoid an in-court process through some type of out-of-court workout, like a forbearance, recapitalization or exchange offers. But, sometimes companies that have waited too long to restructure their liabilities desperately need the protections afforded by the U.S. bankruptcy laws.

In contrast, consumer bankruptcies have dropped to 298.080 during the first half of 2020, a 23% decrease from the 388,594 consumer filings during the same period last year. This drop was likely due to courts being closed or access to courts being restricted all over the country. But, even these types of bankruptcies could rise with most of the government assistance ending in the second quarter of 2020.

What should you be doing if you are a bankruptcy attorney or head of a corporation that has struggled financially, even before the COVID-19 pandemic?

The head of distressed companies, which likely had their financial problems magnified by the pandemic, should consult with restructuring counsel—especially ones at full-service firms–to weigh all their options, including how to maintain liquidity, engage in work-out discussions with lenders and plan for other contingencies. There is a large misconception that all restructuring lawyers do is tell companies that they need to file bankruptcy. Quite the contrary, most of the time, good restructuring counsel, which has access to a variety of disciplines, like securities, tax and energy, can find a business resolutions that avoid filings, provide more certainty to stakeholders and are less expensive. Unfortunately, you do not read about those success stories as much as you do about the cases that file, and that's because few ever want to disclose that they were in financial trouble.

Bankruptcy lawyers, who are already busy, should assess the strength of their bench and their bandwidth. It's time to ramp up with restructuring professionals, because the economy is expected to start feeling the full effect of the COVID-19 pandemic during the third and fourth quarters of 2020, when Main Street Lending and other government programs are set to expire.

What questions should you be asking your bankruptcy attorney if your corporation is struggling to stay afloat?

The questions to ask depend on the sophistication level of a company. Many middle-market companies, who seem to be struggling the most, already have chief financial officers who are somewhat familiar with the restructuring process and have a good understanding of how to reorganize their company. They just need assistance to help implement their plan of reorganization either inside or outside of court. At the lower middle market, there is generally more of a learning curve. Prospective clients have to start with the questions of, what is the extent of my problems and how can we try to fix our issues outside of bankruptcy. An understanding of the company's capital structure is fundamental, and contingencies, like litigation or debt maturities, also have to be taken into consideration.

Keep in mind that a successful reorganization in or out of court requires planning and skill. The more a distressed company is able to plan ahead, the more flexibility it maintains throughout the process. Liquidity is generally a big concern, because when a company is running out of money, it's options dwindle every day. Thus, the phrase "cash is king" has become an axiom in the preparatory process. Skills require not just knowing the law, the industry and local customs, they also require being able to communicate effectively, organize a team of professionals, and negotiate with various parties, whom often have competing interests.

In sum, prospective clients should not be afraid of spending a little time discussing their problems with a restructuring attorney. They don't bite. At a minimum, the client may gain a different perspective about potential solutions to their problems.

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