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2020 Bankruptcy Trends And Sectors To Watch In 2021

By **Suzzanne Uhland and George Davis** (December 22, 2020, 10:31 AM EST)

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For restructuring professionals, 2020 was particularly exhausting. Some of the largest filings of the year took place in the second and third quarters as the full impact of COVID-19 was felt.

These included The Hertz Corp., Frontier Communications Corp. and Chesapeake Energy Corp.,[1] with many of us working around-the-clock on a number of megafilings. The fourth quarter has given us a respite and time to ask ourselves: "What's next?"

Before launching into our predictions for 2021, we briefly review what did, and did not, happen in 2020. After a brief summary of the highlights in 2020, we will provide you some of our thoughts about what might be in store in 2021, with the caveat that we live in times that are marked by their historic unpredictability.

2020 – Year in Review

First, retail was notably impacted with 46 retailers[2] — so far — filing for bankruptcy this year. Several of these situations were an acceleration of filings of overleveraged, or overleased, retailers that were struggling to adjust to the reality of the digital age. This was borne out through filings by legacy department store chains, J.C. Penney Co. Inc., Neiman Marcus Group Inc. and Lord & Taylor LLC, and discounters, Stein Mart Inc. and Century 21 Department Stores LLC, which could not survive 2020's decline of in-store foot traffic.

Additionally, those retailers that were private equity portfolio companies also struggled under onerous debt burdens. The retail real estate industry also grappled with the effects of the pandemic with fewer rent collections coming in and thousands of store closures with fewer companies looking to open new locations. The recent bankruptcy filings by mall owners CBL & Associates Properties Inc. and Pennsylvania Real Estate Investment Trust highlight these stresses.

Surprisingly, filings related to COVID-19 were limited to fewer industries than first feared, largely due to the swift and unprecedented stimulus measures that restored confidence in markets and helped fuel a record corporate debt spree.

For instance, it was expected that rent holidays, eviction moratoriums and mortgage relief would result in severe financial distress across a wide array of real estate business, including mortgage servicing and commercial property managers. Companies across these industries have broadly managed to defy expectations and withstand the initial COVID-19 shock without the need for bankruptcy relief.

But the first wave of stress was still seen in sectors most directly dependent on the consumer's physical presence, most notably fitness centers (24 Hour Fitness Worldwide Inc., Gold's Gym International Inc.), restaurant chains (California Pizza Kitchen Inc., CEC Entertainment Inc.) and cinemas (Studio Movie Grill Holdings LLC, Cinemex USA Real Estate Holdings Inc.).

Of course, some travel-related sectors like airlines have benefited from $25 billion of direct aid, as part of the $2.2 trillion Coronavirus Aid, Relief, and Economic Security Act package. Ancillary sectors such as car rentals, including The Hertz Corp., have borne the brunt instead.

But the big story of 2020 has actually been energy.

Saudi Arabia's March 6 announcement that it would cut oil prices and increase production led to a sharp decline in already low oil prices. In the first 10 months of the year, 101 oil companies with a total of $94 billion in debt filed for bankruptcy.[3] More than 95% of these bankruptcies fell under the upstream exploration and production and oil field services segment with the largest filings being Diamond Offshore Drilling Inc., $11.8 billion, Chesapeake Energy Corp., $11.8 billion, and McDermott International Inc., $9.9 billion.

These companies experienced a double whammy as a drop in demand induced by COVID-19 coincided with a hydrocarbon oversupply. While an agreement to cut production levels by 10 million barrels per day was ultimately reached on April 12, the extreme supply and demand disparity has continued, and oil prices remain at historically low levels. As discussed below, further stress and accelerated deleveraging is expected to be a trend in 2021.

2021 – Looking Ahead by Sector

The outlook for next year has brightened following the promising recent news on three vaccine candidates. As markets and investors look to 2021 with increasing hope, thoughts are also starting to turn to the economic legacy of COVID-19.

Spurred on by the large fiscal stimulus in 2020 and expectations for 2021, companies and governments globally have issued a record $9.7 trillion of bonds and other debt this year.

Global debt has risen $15 trillion to $272 trillion in the first nine months of the year, and is set to hit $277 trillion by year-end. U.S. federal debt is forecast to exceed 100% of gross domestic product next year.[4]

As we see the recovery gain momentum, consumers and businesses could face the challenges of inflation driven by record government spending and accommodative monetary policy. Companies that have become more levered and increased their debt levels through the pandemic could feel the full impact of rising rates — particularly if we see a sustained lag in demand in certain industries.

Moreover, should the recovery prove to be more sluggish than hoped, these highly levered companies may not be positioned to withstand a period of sustained depressed revenues, leading to the next round

of bankruptcy filings.

Taking these factors into account, we expect more corporate stress to surface as we head into 2021.

Energy

As discussed above, hydrocarbon prices reached historic lows in 2020. There are no signs that prices are likely to rebound significantly in the near term, given the increasing prevalence of cheaper generation sources, e.g., renewables, pandemic-related demand reduction and geopolitical factors.

In addition, as a result of the earlier wave of oil and gas bankruptcies circa 2014, much of the debt issued by companies in the industry is held by sophisticated investors who are repeat players in Chapter 11 — e.g., distressed credit funds — and not afraid of the specter of their issuer or borrower taking another trip through Chapter 11.

Filings to date have been weighted toward those most directly impacted by commodity prices — upstream exploration and production companies — whereas filings by midstream oil and gas companies — those responsible for gathering and transporting hydrocarbons — have, to this point, been more limited.

Though these companies are less directly impacted by commodity price fluctuations, they are still indirectly impacted by production curtailment in the upstream sector and that may result in increased distress in this sector in 2021.

Of even graver concern for midstream companies, however, is the possibility of their upstream counterparties using the Chapter 11 process — and specifically, the power to reject burdensome executory contracts — to shed or renegotiate gathering agreements that are, from the midstream party's perspective, profitable, valuable and essential to the midstream party's ability to recoup its capital investment in gathering infrastructure for the upstream producer.

Whether the array of real property law protections contained in these gathering agreements are sufficient to prevent rejection remains the subject of considerable litigation that has to date resulted in differing outcomes.

Over the past five years, this litigation has resulted in four decisions from four different bankruptcy courts applying the law of four different states, with two bankruptcy courts, the U.S. Bankruptcy Court for the District of Delaware and the U.S. Bankruptcy Court for the Southern District of New York, reaching the conclusion that those agreements could be rejected, and two others, the U.S. Bankruptcy Court for the Southern District of Texas and the U.S. Bankruptcy Court for the District of Colorado, reaching the opposite result.

To the extent that midstream parties end up on the losing end of this litigation, and are forced to give back, or lose entirely, the benefits of their gathering agreements due to counterparty bankruptcies and the threat of rejection, this would also contribute to an increase in Chapter 11 filings by midstream companies as well.

Automotive

The automotive and automotive-related sectors are facing a number of headwinds as they have levered

up through the crisis. The industry borrowed heavily to secure some stability during the first few months of the pandemic, drawing down revolving credit facilities, taking on new loans and hitting capital markets.

While monthly U.S. auto sales have rebounded from June after halving in April, the fragile economy continues to see consumers and businesses pivot away from spending on nonessential goods. A shortage in steel supply, not seen since 2004, and the effects on the supply chain resulting from the U.S.-China trade negotiations will likely continue, with a period of heightened costs and uncertainty expected to persist through 2021.

Similar to prior challenges to this sector, the impact is likely to be felt by replacement parts suppliers, wholesalers and raw materials suppliers, particularly those that are highly leveraged.

Education

The pressures of the pandemic on education could lead to legal challenges regarding the accessibility of Chapter 11 for higher education restructurings or out-of-court restructurings that push the envelope. Colleges and universities will remain under pressure with the prospect of application deferrals, fewer international students and a reduction in tuition revenues.

But, without a change in the law, these institutions will lose federal student financial aid if they file Chapter 11, eliminating that path for addressing unsustainable debt burdens. Without Chapter 11 as a viable option, we could see institutions turning to out-of-court coercive restructurings or exchange offers, reminiscent of the Marblegate Asset Management LLC v. Education Management Corp. saga in 2014 — potentially with the same litigation fallout.

Conclusion

While there is reason for optimism heading into 2021, uncertainty will remain a fact of life. A number of factors loom — delays in the vaccine rollout, continued commodity price turbulence and changes to fiscal policy in the new administration, among many others — with the potential to roil capital markets and jeopardize a fragile recovery.

Uncertainty regarding the pace of recovery could further intensify corporate stress and the need for deleveraging across an array of industries, even if brighter days do indeed lie ahead. Whatever the New Year may bring, restructuring professionals can expect to remain in high demand to assist clients across the capital structure in navigating these extraordinary times.

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Disclosure: Latham represented Barclays as agent in connection with McDermott International's Chapter 11 proceedings, and is representing Barclays as agent for the lenders under Hertz's senior secured credit and letter of credit facilities in connection with Hertz's Chapter 11 proceedings.

The firm is serving as securitization counsel to Deutsche Bank as agent for the lenders in Hertz's asset-backed securities fleet financing facility.

The firm is representing Neiman Marcus Group Inc., a nondebtor parent, in the Chapter 11 bankruptcy of its Dallas flagship store.

The firm is also representing Morgan Stanley as lender, administrative and collateral agent in debtor-in-possession bankruptcy funding for 24 Hour Fitness.

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[1] The Hertz Corporation (22 May), Frontier Communications Corporation (14 April), Chesapeake Energy Corporation (28 June).

[2] S&P Global.

[3] Reuters.

[4] Refinitiv, Institute of International Finance.