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SZABO ASSOCIATES, INC. VOLUME 35, ISSUE 3, SEPTEMBER 30, 2020

MORE is better than less.

Dear Friends:

The past six months have brought unimaginable challenges to businesses in every sector of the economy. Tragically, many businesses have not been able to survive while the future of others remains in question, with small businesses suffering the greatest losses. Fortunately for some, a new Subchapter V of Chapter 11 of the Bankruptcy Code may prove to be a lifeline. This issue's feature discusses the law, cases so far, and related payment issues for credit and collection departments.

Our quality awards banquet on August 24 at Maggiano's in Buckhead was great fun. Two-thirds of our employees attended in person, with one-third attending via ZOOM. Iomie Kendrick, Richard Hunter, and Vernon Johnson received awards for 2020.

Our fall is filled with virtual events. We will conduct a distance learning seminar/workshop, "Creating a Strategic A/R Plan During Economic Disruption," for MFM/BCCA on September 24. Szabo will be a sponsor for the GAB's Gabby Awards on October 24, and also for the MFM/BCCA seminar/workshop the week of November 9. Other events are the NAB/RAB Radio Week, October 5-9; NAB Sales & Management TV Exchange, October 14-15; MFM's Media Outlook, October 20-21; and the NAB Show NY, October 19-29.

Best wishes for a fine fall season,

Robin

Robin Szabo, President
Szabo Associates, Inc.

Small Business Woes . . .
A New Chapter May Offer Relief

Small businesses are the lifeblood of the American economy. Almost 50 percent of American workers are employed by businesses with fewer than 500 employees and, according to the Small Business Association (SBA), they account for 44 percent of all economic activity.

The COVID-19 pandemic, which has hammered businesses small and large, has hit small businesses particularly hard. Because many small businesses depend heavily on foot traffic and operate on slim margins, they are especially vulnerable to the ripple effects of a general shutdown. In a survey of small-business owners conducted in late July by CreditCards.com, about 35 percent of respondents said they have dipped into their personal funds, such as personal credit cards and/or savings, to stay afloat. Additional resources included business credit cards, business savings accounts, and loans, including the Paycheck Protection Program (PPP), which is part of the CARES (Coronavirus Aid, Relief, and Economic Security) Act. Added together, about 70% said they have relied on one or more of those sources to stay in business since the COVID-19 crisis began.

The PPP loan application window closed on August 8th, after Congress extended the deadline from June 30th to allow for greater participation, although most businesses applied early. According to a survey from the National Federation of Independent Business (NFIB) Research Center published the third week in July, most borrowers (71 percent) had used their entire loan, with the remaining 29 percent likely not far behind. Almost half (46 percent) of surveyed PPP borrowers anticipated needing additional financial support over the following 12 months. Borrowers are now waiting for lenders to start accepting loan forgiveness applications, in accordance with PPP rules, as Congress wrestles with the if, what, and when of additional assistance.

In addition to fixed costs such as mortgage/rent/lease payments, unanticipated local and state reopening actions have also been costly for business owners. Many businesses increased perishable inventories to prepare for eased restrictions, only to have those restrictions stay in place or tightened even further. Also, according to the NFIB, the constant concern and challenge of managing the health and safety of themselves and their employees have taken a considerable toll on owners.

The sad reality for many small businesses is that their temporary closures might become permanent. Oddly, legislation signed into law in August 2019, months before the pandemic began, may prove to offer a lifeline to struggling small companies.

Small Business Reorganization Act.
No one could have anticipated in August 2019 that our strong U.S. economy would virtually grind to a halt the following March due to a virus. Long before then, however, Congress recognized that small

—continued on page 2

A New Chapter —

—continued from page 1

businesses had long endured challenges unique to their size that prevented their participation in Chapter 11 reorganization.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) promised to streamline Chapter 11 for small businesses by providing for a one-step solicitation and confirmation process. The same law, unfortunately, imposed greater reporting requirements and other procedural burdens that offset or surpassed the benefits for many.

Enter the Small Business Reorganization Act (SBRA), which is specifically intended to make Chapter 11 Bankruptcy more accessible to small businesses. The law, which went into effect on February 19, 2020, created a new Subchapter V of Chapter 11 of the United States Bankruptcy Code. SBRA strikes a balance between Chapter 7 and Chapter 11 bankruptcies, enabling small businesses to survive bankruptcy and retain control of their operations while also benefitting creditors and the economy.

SBRA defines a small business debtor as a person or entity "engaged in commercial or business activity" that owes aggregate secured and unsecured debts, excluding debts to insiders and affiliates, of $2,725,625 or less, of which at least 50 percent resulted from commercial or business activity. In response to the COVID-19 pandemic, the CARES Act amended SBRA, increasing the amount that a debtor may owe and remain eligible to proceed under Subchapter V to $7.5 million for a period of one year beginning on March 29, 2020.

The Differences.
Subchapter V, under which debtors must affirmatively elect to file, allows them to stay in business (unlike Chapter 7), while allowing them to avoid the more costly requirements of Chapter 11.

Absolute priority. SBRA eliminates the Absolute Priority Rule, under which an owner of a bankrupt business cannot retain his or her equity interest unless all creditor classes vote to accept the reorganization plan or are otherwise paid in full. Under Chapter 11, equity holders must inject "new value," usually additional capital, into the business in order to retain an equity stake.

SBRA allows the debtor to retain ownership even if unsecured creditors are not paid in full, as long as the plan provides for the payment of all projected "disposable income" over a three-year period or "such longer period not to exceed five years as the court may fix…" Additionally, if the debtor used a primary residence as security for a loan to fund the business, the debtor's plan may modify the loan.

Creditor's committee. Chapter 11 cases usually require an appointed committee of creditors holding unsecured claims (UCC), which places expensive and time-consuming demands on the debtor to provide diligence and discovery materials. In a Subchapter V case, the court may appoint a UCC only "for cause," which should be the exception in SBRA proceedings.

Trustee. A U.S. trustee in a traditional Chapter 11 case is appointed for cause, such as fraud or gross mismanagement. The trustee plays a major role in monitoring the progress of the case and supervising its administration and is responsible for monitoring the debtor-in-possession's operation of the business and the submission of operating reports and fees. By law, the debtor must pay United States Trustee (UST) quarterly fees until the case is converted or dismissed.

Subchapter V procedures include the appointment of a standing trustee, under the supervision of the Department of Justice, with no requirement for the business owner to pay trustee fees. The standing trustee is not an operating trustee; instead, the small business remains a debtor-in-possession. The trustee's primary function is to facilitate a consensual (if possible), indiscriminate, fair, and equitable plan between the debtor and creditors. The participation of an impartial third party may be valuable for a business whose creditors are unwilling to make reasonable concessions.

Mandatory credit support. A Chapter 11 ordinarily requires at least one case of "impaired creditors" (those whose rights are being changed or modified in any way) to vote to accept the plan if any class of creditors votes to reject it.

Under Subchapter V, a plan can be confirmed without any creditor support as long as it satisfies the confirmation requirements. The modified provisions for "cramdown" permit the court to approve the plan over creditor objection if the plan does not "discriminate unfairly" and is "fair and equitable" as to each class of dissenting impaired creditors that votes against the plan. Essentially, a plan will be confirmed if it provides that all projected disposable income for three to five years will be used to make plan payments.

Rocket docket. A Chapter 11 proceeding can drag on, seemingly, forever. The debtor has the exclusive right to file a plan for the first 120 days of the case ("exclusivity period"), which courts often extend, after which others can propose a plan. Prior to any vote, the court must also approve a "disclosure statement," documenting the debtor's history, events to date in the proceeding, key terms of the plan, and more.

With Subchapter V, only a debtor may propose a plan, and must do so within 90 days of filing. The exception to the requirement is "circumstances for which the debtor should not justly be held accountable." SBRA requires the disclosure of only three items: a brief history of the debtor's business operations, a liquidation analysis, and projections regarding the ability of the debtor to make payments under the proposed plan. The requirements of a disclosure plan and competing plans are eliminated, preventing contested hearings that prolong the reorganization process and increase costs for debtors.

A "status conference" takes place 60 days after the date of filing. Not later than 14 days before the conference, the debtor must give the court, the trustee, and interested parties a report detailing the efforts the debtor has made and will make to attain a consensual plan of reorganization.

Debt payment. Chapter 11 normally requires the debtor to pay administrative fees at plan confirmation. Post-petition claims must be paid as they come due.

Subchapter V, much like Chapter 13 cases for individuals with regular monthly income, allows debtors to spread their debt over three to five years, during which time they must devote their projected disposable income to paying creditors. Post-petition debt and administrative fees may be stretched out over the life of the plan. Debts are not discharged until the debtor completes all of its plan payments.

Preference Payments.
In light of the COVID-19 battered economy, we can expect a barrage of bankruptcy filings and, in their wake, demands for return of "preferential" payments. The Bankruptcy Code defines a preferential payment as a payment or other transfer made in the 90 days prior to the bankruptcy filing and made on account of indebtedness owed by the debtor to the creditor prior to the bankruptcy.

In a recent interview with *Credit Today,* Attorney Richard Macias of Maynard Cooper & Gale discussed the issue of preference payments. "Basically," he stated, "during the 90-day pre-petition period, the Bankruptcy Code starts with a presumption that any payments should be voided." The Code presumes the debtor was insolvent during that time, and so any transfer should be voided with the money "clawed back" to the estate to be shared by all creditors.

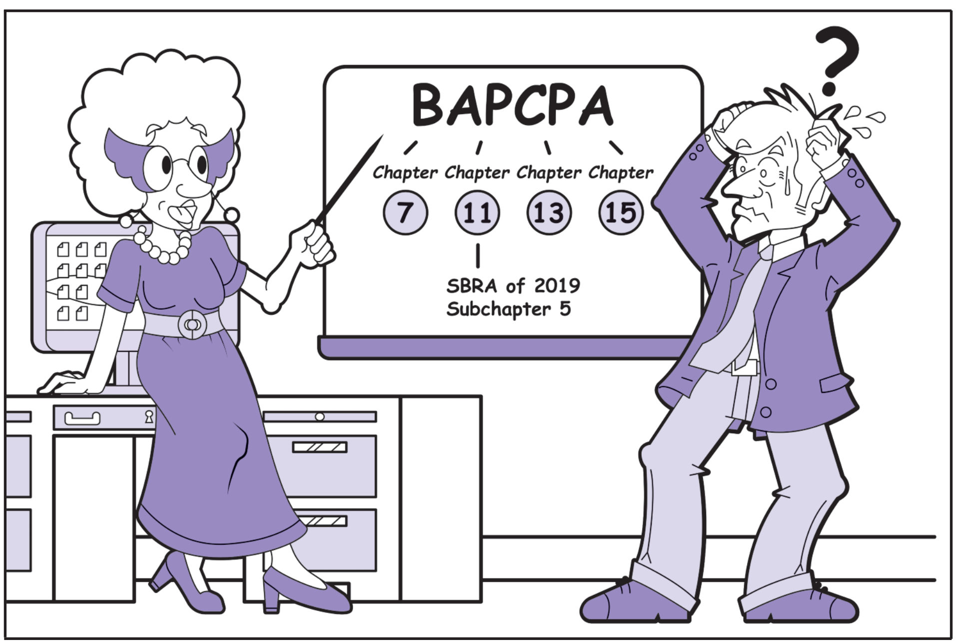
The demand usually begins with a collection demand letter that includes the dates and amounts of payment within the preference claw-back period. Macias suggests that creditors look back at least 100 days from the filing date, because the date of the preference is the date the payment actually clears the debtor's bank, not the date of the payment or the date the creditor receives the payment.

Defenses. The two primary defenses are either that the payments were made in the ordinary course of business (OC) or for new value (NV), usually in the form of additional goods or services on credit. If successful, the NV defense entitles the creditor to reduce its preference exposure by offsetting the new value against the payment.

For both, Macias advises preparing a preference analysis—a spreadsheet that shows a chronological listing of the dates when you received payments and the number of days that elapsed between invoice and payment. The longer you can "look back," perhaps two or three years, the better for determining whether the preference payment was consistent with an established payment pattern. If you can show a consistency between the preference period and the look-back period, you have the start of an OC defense. The spreadsheet analysis, showing dates of payments and subsequent new value of services rendered on credit, can provide the start of an NV defense.

If, however, you change payment terms for a struggling slow-paying debtor (for example, net/20 for a customer accustomed to 45 days), your preference defense may suffer. Arguably, such a change makes the prior pattern of payment irrelevant.

SBRA changes to preference rules. New Subchapter V rules require the debtors' representatives to conduct reasonable due diligence, taking into account known or reasonably knowable "affirmative defenses" to a preference action, before starting the preference action. The rule is a head-scratcher for many, since it is plagued with ambiguities. Macias cites several examples: How much due diligence is necessary to be "reasonable"? How are the creditors' defenses knowable to the debtors? Does this place more emphasis on early negotiation to reach a settlement? Questions such as these will need to play out and be clarified in the courts rather quickly.



So Chapter 5, or SBRA, is technically Subchapter 5 of Chapter 11, which has some parts of BAPCPA but is different and actually less complicated in some ways.

Cases So Far.
According to a survey of cases reported in Westlaw Online Legal Research, the most litigated issue under SBRA in its early days of enactment has been whether a debtor who had filed under Chapter 11 or another chapter of the Bankruptcy Code prior to February 19, 2020 (the effective date of SBRA) may elect to proceed under Subchapter V.

Amended filings. Courts in five states have allowed debtors whose cases were pending prior to that date and who could not have taken advantage of the rights afforded by SBRA when their cases were filed to choose to proceed under Subchapter V. All of the cases involved debtors owing less than $2,725,625; however, nothing in the courts' analyses or in the CARES Act would prevent a debtor owing $7.5 million or less who filed prior to February 19, or who filed on or after February 19 but before March 27, 2020, from electing to proceed under Subchapter V now.

—continued on page 4

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A New Chapter —

—continued from page 3

Commercial or business activity. Judgments so far provide early indications that bankruptcy courts will be liberal in interpreting the requirement that a debtor must be engaged in "commercial or business activity" to qualify as a business debtor. Neither the Bankruptcy Code nor SBRA defines those activities.

A South Carolina filer, the sole member of an LLC and owner of 49 percent of a corporation's stock, was not engaged in any business. Both businesses had failed before the debtor filed and were no longer operating; however, the court determined that he was engaged in commercial or business activity because he was "addressing residual debt" left by the businesses, and the debts accounted for more that 50 percent of his outstanding debts.

A secured creditor in a California case objected to a debtor being allowed to proceed under SBRA on the basis that at least 50 percent of her debts did not result from commercial or business activities. The creditor's loan accounted for more than 50 percent of the debtor's debts and the proceeds had been used to buy the debtor's residence, in which she began operating a bed and breakfast "within the first year" after the property was purchased. The court found that the debt did, in fact, result from a commercial activity since the debtor planned to operate the business in her residence when she bought it, even though she did not start operating it as a business until later.

Plan confirmation. A Pennsylvania Chapter 11 case in which the court had ordered the debtor to file a plan and disclosure statement, and the debtor's secured lender had moved for appointment of a trustee, was undercut when the debtor elected to proceed under Subchapter V. Over the lender's objections, the court allowed the debtor to proceed under Subchapter V.

At least initially, case judgments have indicated liberal interpretation of SBRA in favor of debtors. The economic effects of the COVID-19 pandemic may encourage a continuation of efforts to help debtors reorganize under SBRA rules.

Small businesses are an essential source of employment, a recognized proving ground for entrepreneurs, a source of innovation and competition, and vital to local communities. According to McKinsey & Company, many were vulnerable even before the crisis, with the median small business holding only a 27-day cash buffer in reserve.

The SBRA has given small businesses, their creditors, and the economy an opportunity to help secure a better future amid the insecurities faced by all Americans. In the meantime, media properties should understand the rules regarding Subchapter V and the remedies provided for maximizing debt collection in these challenging times. ♦