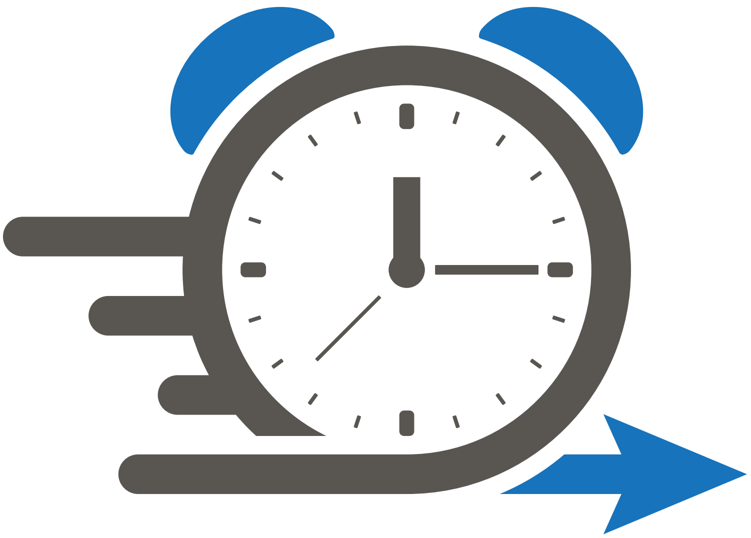

A Short Window: The Timely Opportunity of Small Business Chapter 11 Financing

The Small Business Reorganization Act has made several important changes to the Bankruptcy Code, although many will only be available until March of 2021. Steven N. Kurtz outlines the most important changes and how they can benefit small businesses that may file for Chapter 11, particularly due to the continued economic disruption of the COVID-19 pandemic.

As of writing, many of us are working from home and adjusting to the "new normal." The screeching halt of our economy caused by the COVID-19 pandemic is obviously having repercussions. In an effort to lessen the pain, on March 27, President Donald Trump signed the CARES Act. This piece of legislation contains a number of stimulus packages and includes a critical amendment to the Bankruptcy Code, which increased the debt ceiling for a debtor to file a Chapter 11 case under the Small Business Reorganization Act of 2019 from $2,725,625 to $7.5 million. This critical amendment to the Bankruptcy Code, coupled with the streamlined procedures inherent in the SBRA, presents some very good business opportunities for the factoring and asset-based lending industry. Factoring and asset-based lending have always been the lenders of choice for debtor-in-possession financing, and this

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new law should further solidify this symbiotic relationship.

THE SBRA

The SBRA was enacted in 2019 and became effective on Feb. 19, 2020. It simplifies the Chapter 11 process for small businesses and makes it economically viable. Before the SBRA was enacted, Chapter 11 was not a cost-effective way for a small business to reorganize its debt which caused many small businesses simply to fail.

The multiple benefits of filing a Chapter 11 case under the SBRA are as follows. There is generally no creditor's committee, creditors cannot file competing reorganization plans, a separate disclosure statement is not required as part of the reorganization process, there are no quarterly payments to the United States Trustee's Office, the "new value" requirement for the equity owners to contribute funds to the plan when not paying creditors 100% of claims is waived and debtors no longer must pay all administrative claims in full on the effective date of a Chapter 11 plan. Another important change in the SBRA is a small business trustee is appointed to the case to monitor the debtor and facilitate and distribute bankruptcy plan payments after the Chapter 11 plan is confirmed.

These changes to the Bankruptcy Code are long overdue for small businesses. The increase in the debt ceiling likely will help many small businesses reorganize their affairs and recover from the COVID-19 crisis. The increase in the debt ceiling applies to cases filed on or after March 27, 2020 and will expire on March 27, 2021. This means that there will be a short window of opportunity to take advantage of this new law.

Although I don't have actual statistics, most DIP financing deals involve factoring or asset-based lending. The obvious reason for this is if a debtor has a viable business, good-paying customers and/or other viable collateral, balance sheet tests are irrelevant and the DIP financier has a nice deal which has been blessed by the court. The challenges for many DIP financing deals are the strict rules governing a Chapter 11 plan confirmation, the high costs associated with a Chapter 11 case and the litigation process unique to the bankruptcy system.

An additional roadblock to a successful DIP financing deal can often be the creditors' committee and U.S. trustee. The creditors' committee is composed of unsecured trade creditors, who act as a governing party, hiring lawyers and other professionals for whom debtors pay. Unfortunately, in practice, this is sometimes nothing more than an added layer of expense and parties look to the DIP financier for a carve-out from collateral to pay attorney fees.

TRADING TRUSTEES

The U.S. trustee is the branch of the Justice Department tasked with overseeing the Bankruptcy Code. In theory, for Chapter 11 cases, the U.S. trustee oversees the integrity of the bankruptcy process, but their track record for success is not nationally uniform. In certain jurisdictions, such as Delaware and the Southern District of New York, the U.S. trustee has used its role to facilitate a number of successful reorganizations. In others, when the U.S. trustee may not be as creative, debtors can work with him/her to achieve a successful reorganization. Unfortunately, there are many jurisdictions in which the U.S. trustee is actually a hindrance to making a case work because the office is highly bureaucratic and not business friendly.

The virtual elimination of the creditors' committee and the U.S. trustee, coupled with the other major changes to the Bankruptcy Code in the SBRA, creates a perfect storm of opportunity for DIP financing. A SBRA trustee will replace the U.S. trustee and possibly the creditors' committee.

In most cases, the SBRA trustee will be an experienced bankruptcy professional from a particular district's existing pool of bankruptcy trustees. Every jurisdiction has a standing panel of Chapter 7 trustees. For the most part, Chapter 7 trustees, who often serve as Chapter 11 trustees, are usually lawyers, accountants or business people. Bankruptcy trustees typically are compensated by the size of the estate that they handle. While bankruptcy trustees often have the ability to initiate litigation for preferences, in most instances, the business realities of being a bankruptcy trustee require the person to start with nothing in the estate, and he or she has to find assets or money. The system is such that bankruptcy trustees must make business deals because they are managing a shrinking ice cube. Based upon the business realities, it is reasonable to presume that a SBRA trustee will understand the need for DIP financing and will work to achieve a deal. If done right, the SBRA can be a friend and advocate for terms in an agreement before the Bankruptcy Court.

DIP financing is usually, but not always, done at the beginning of the case. Typically, a Chapter 11 debtor files what are known as first day motions, which address a number of issues early in the case and usually involve seeking permission to use a lender's cash collateral, pay employee wages, address utility deposits and pay certain critical vendors. Many first day motions also seek to approve the terms of a DIP financing transaction. The DIP financing transaction requires notice to all parties, a court hearing and disclosure of all relevant terms.

LEGAL FACTOR

MAY/JUNE 2020

A debtor's counsel will want to approve and review all pleadings, including the DIP financing order, before those papers are filed with the court and served on all the parties. Once the court approves the transaction, a debtor will be afforded a number of protections and then it is full steam ahead for the DIP financing deal.

As mentioned previously, the window for the increase in the debt ceiling is set to expire on March 27, 2021. Hopefully, the debt ceiling will be made permanent or extended for an additional period. The SBRA is long overdue and will be beneficial to many parties. The increase in the debt ceiling means more small businesses will utilize this process. Hopefully the SBRA will be a good source of business as our industry helps other businesses recover from the effects of the COVID-19 crisis. •

RETAIL AMID COVID-19

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customers in different parts of the country and different countries around the world, which have all been affected differently by COVID-19. As regions reopen and inevitably tighten up again, it's important that companies plan accordingly to get products to the places where they can easily be sold and willingly bought.

The challenges surrounding COVID-19 also present an opportunity for companies to rethink their brick-and-mortar footprints and close non-performing locations. Long-term or restrictive leases may make that more difficult for some, and only brands that are consistently investing heavily in building out e-commerce platforms will be able to do so successfully.

Assessing the creditworthiness of retailers will be one of the biggest hurdles for brands to overcome. In fact, any brand without credit protection coverage heading into the remainder of 2020 and looking ahead to 2021 should be concerned. Factoring is a valuable tool for any brand operating in this environment and selling into retail channels. Not only does factoring help businesses simplify operations and reduce overhead for things like collections and receivables management, but an experienced factor in this environment can help brands avoid bad debt, especially when selling to retailers who aren't Target, Costco or Walmart.

PLANNING FOR THE FUTURE

While companies continue to feel the effects of this pandemic, factoring and purchase order financing are once again among some of the most essential tools available. Brands simply cannot afford to get caught with inventory or be exposed to bad debt from a retailer. In this environment, one bad season or a brush with a retailer with bad credit spells doom for a brand.

But companies should be selective about which partners they select and only work with those who know the retailers well. However, the continued move toward omnichannel distribution requires a lending source that can also support the e-commerce inventory funding requirements of a business. Experience helping brands operate in challenging environments is also paramount, as is expertise with international trade, navigating complex supplier relationships and negotiating contracts.

The future of retail is still very uncertain. While no one has a crystal ball, it's becoming clearer that brands must make difficult decisions and adapt if they are to survive this pandemic. The brands that will ultimately thrive in this climate will be the ones that remain flexible, embrace creativity, stay on top of shifting styles and trends, and take steps to understand their customers' shifting needs and desires — all at a price point based on 30 million or more Americans being out of a job this year. •

YOU be the JUDGE

ANSWERS FROM PAGE 9

1. The factor gets the $100,000 since it is a payment on the assigned account. Under UCC §9-406, after receiving the notice of assignment, the only way for the account debtor to discharge its obligation on the assigned account is by paying the assignee (the factor).

2. Yes, the account debtor must pay the bank. The account debtor's obligation to the bank arises under its application for the L/C and is not a payment of the assigned account.

3. The account debtor could have made the factor the beneficiary under the L/C.

4. No.

5. Under UCC §2-325(2), "[t]he delivery to seller of a proper letter of credit suspends the buyer's obligation to pay. If the letter of credit is dishonored, the seller may on seasonable notification to the buyer require payment directly from [them]." If the L/C stated that it is issued to secure a specific purchase order or contract or sale, and the L/C was issued before the factor delivered its notice of assignment, the account debtor would have no duty to pay the factor until the L/C expires or is drawn upon. If, however, the L/C was issued after the factor delivered its notice of assignment, it is unclear how UCC §2-325(2) would interact with UCC §9-406. It could be that the issuance of the L/C was a payment to the client after the account debtor's receipt of the notice of assignment and, as a result, the issuance of the L/C did not discharge the obligation of the account debtor to the client. •

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