Debt Management, Restructuring & Bankruptcy Considerations for Small Businesses in Light of COVID-19

Part II of Debt Management Series

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Disclaimer

- This presentation is current as of December 8, 2020. The contents of this presentation and the topics we discuss today are not comprehensive, should not be construed as legal or tax advice, and should not substitute for a consultation with an attorney and/or an accountant. Business owners should seek advice based on their particular circumstance from an independent legal advisor.

- Bankruptcy implicates federal and state law considerations - the contents of this presentation are not state-specific and business owners should be sure to seek advice in the appropriate jurisdiction(s). Nothing in this presentation creates an attorney-client relationship with either of Start Small Think Big or Paul, Weiss, Rifkind, Wharton & Garrison. These materials are for educational purposes only.

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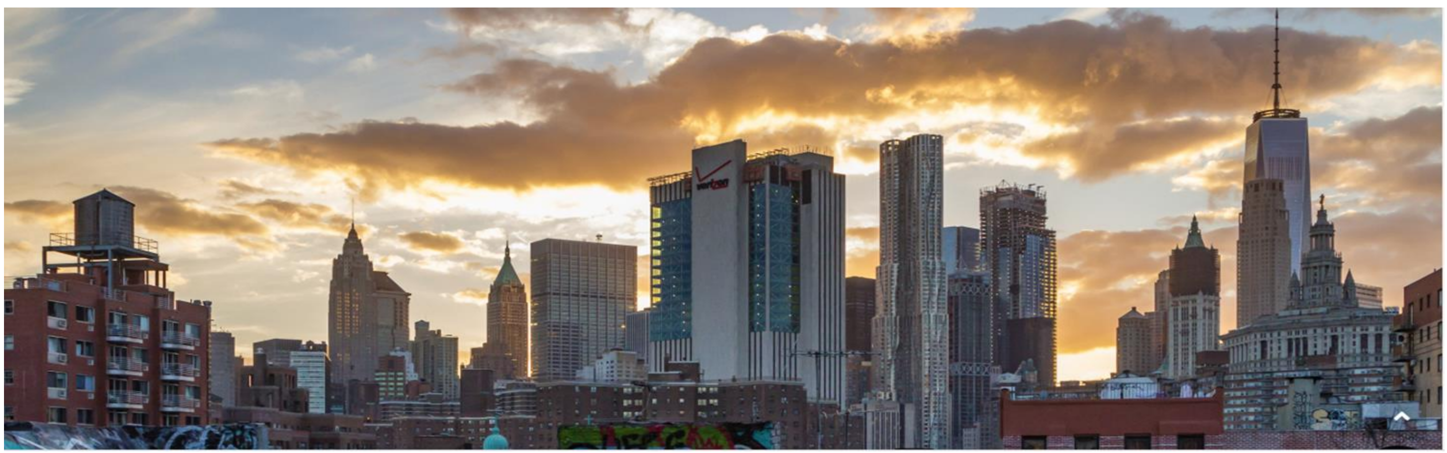
boc network

What's your next step?

Business Outreach Center Network



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BOC Network Programs

- BOC Capital Corp.
- Queens BOC - Entrepreneurship Assistance Center
- Office of Refugee Resettlement (ORR) Microenterprise Development (MED)
- Women's Business Center
- Minority Business Development Agency
- Childcare Business Development Project
- Industrial Business Solutions Provider

For more information, call us at 718.624.9115
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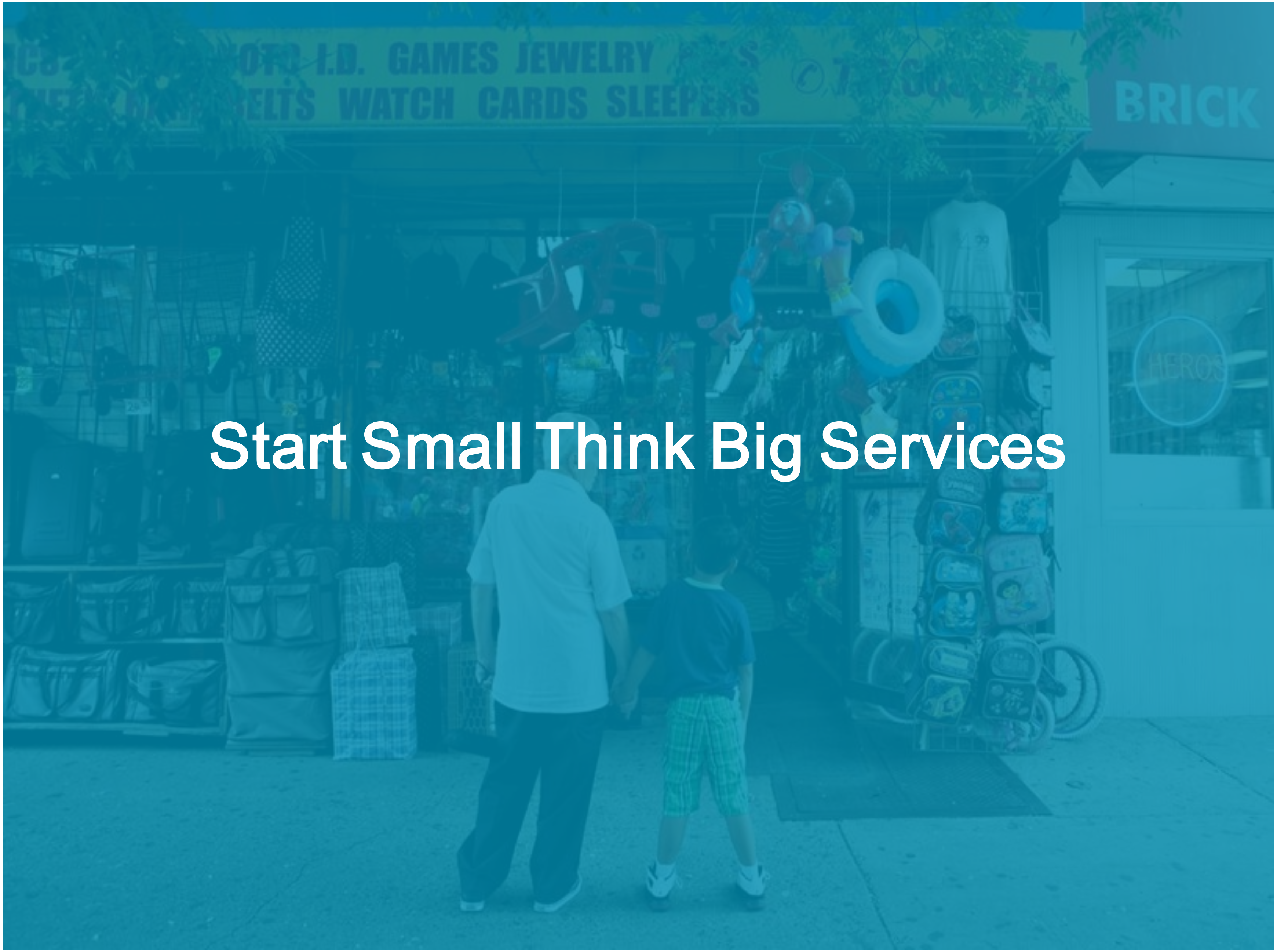

Start Small Think Big Services

Overview

Who We Are

- Start Small Think Big believes that access to high-quality legal, financial management, and marketing services is an essential part of starting or growing a successful small business
- We are a nonprofit organization and focus on pairing entrepreneurs positioned to grow their businesses with top pro bono attorneys and financial and marketing experts

Who We Serve

- We work with under-resourced small business owners

What We Offer

Legal

- Provide clients access to legal information and legal assistance through tailored referrals to volunteer pro bono attorneys
- Volunteer attorneys address clients' legal needs (business entity formation, corporate governance guidance, contract review and drafting, commercial lease review, intellectual property issues, employment law matters, etc.)

Business and Financial

- Provide access to in-house and/or pro bono financial advisors for assistance with small business financial management (bookkeeping advice, business and financial modeling, etc.), and hands-on workshops

Marketing

- Provide access to in-house and/or pro bono marketing advisors for assistance with marketing strategy, website and brand assessment, social media strategy, online advertising, and hands-on workshops
- Connect clients to online and/or in-person vending opportunities such as tastings, pop up shops, markets and fairs, business-to-business sales, etc.

What We Offer

COVID-19 Rapid Response Program ("RRP")

- **Fast tracked, walk-in style** support for small business impacted by COVID-19 and in need of immediate assistance (contract and legal compliance issues, loan/grant applications, financial statement review, website audit, etc.)
- **RRP assistance request form** available at https://covid19.startsmallthinkbig.org/request/

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Client Eligibility Criteria

Eligible Business Stage & Size

- Currently selling goods and/or services (sales over the past 3 months of at least $500) *OR* have a legal impediment that is keeping them from doing so
- Where sales have dropped because of COVID-19 crisis, we consider evidence of sales during the 3 months prior to March 2020
- No more than $1M in business revenue over previous 12 months

Eligible Under-Resourced Business Owners

- Household income generally less than 500% of the Federal Poverty Guidelines
- Household assets generally less than $50,000
- Focus on entrepreneurs from traditionally under resourced communities (identifying for example as people of color, immigrants, women, LGBTQ+, with disability, veterans, etc.) and small businesses helping to create jobs in or provide services to under-resourced communities

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Our Resources

- **Programming agenda:** https://www.startsmallthinkbig.org/workshops-classes
- **COVID-19 resource hub**: https://www.startsmallthinkbig.org/covid19
- **Full Services Application:**
  - English - https://www.startsmallthinkbig.org/apply-now
  - Spanish - https://bit.ly/sstbspanishapp
- **Rapid Response Program Application:**
  - English - https://covid19.startsmallthinkbig.org/request
  - Spanish - https://covid19.startsmallthinkbig.org/request/esp

Agenda

Introduction	The COVID-19 crisis brings a host of challenges to small businesses struggling to generate revenue, access capital and service debt. This webinar aims to help small business owners enhance their skill set manage their business debt and understand their options.
Condensed Debt Due Diligence	Small businesses need to consider various options when evaluating unpaid debt, and/or debt they anticipate being unable to service in the near future. Small business owners should review their current debt or seek advice regarding what documentation and numbers they may need to gather.
Access to Capital: Renegotiation, Refinancing & New Funding Sources	If a small business owner does a debt check with diligence and determines that additional funding sources can cover existing debts, they may attempt to refinance existing debt.
Restructuring & Bankruptcy for Distressed Small Businesses	There are a number of options for business owners struggling to pay their debts (and unable to access sufficient funding to refinance) and paths to address each of these options in bankruptcy court or out-of-court.
Conclusion	Recap of covered and brief overview of actionable next steps.

I. Introduction

Impact of COVID-19 on Small Businesses

- In the wake of the COVID-19 pandemic, more and more small businesses are experiencing financial distress
- Many small businesses are struggling to generate revenue, successfully pivot to profitable models compliant with social distancing measures, access funding and service existing debt
- Small businesses, particularly those that may have limited access to financial markets and whose owners may have made personal guarantees on business loans, need to be aware of the risks they face and their various options for keeping their business afloat
- Depending on the business structure and the assets, business owners may consider any of the following:
  - Renegotiated loan terms (forgiveness options, deferred payments, interest rate reduction, extended loan life term
  - Grants
  - Equity funding
  - New loans and lines of credit
  - Reorganization and payment plan negotiations under bankruptcy
  - Liquidation (*beyond the scope of today's webinar*)
- Before making any decisions, small business owners should be sure to consult with a financial professional to find out what's right for their business

II. Condensed Debt Due Diligence

Assessing the Health of the Business: Considerations and Options When a Small Business is in Distress

- In evaluating options, businesses and their advisors should:
  - Be aware of fiduciary duties, *where the business is not a sole proprietorship or small partnership*
  - Conduct a debt health check with basic due diligence, including ascertaining how to increase leverage from reviewing existing contracts
  - Explore funding available to the business for the purposes of refinancing, renegotiating or paying down existing debt
  - Consider bankruptcy options, *including pros and cons for small/micro businesses employing 10 employees or fewer*
  - Consider "out-of-court" options
    - Renegotiation with creditors
    - State law dissolution
  - Be aware of potential litigation

Fiduciary Duties: Overview for businesses with more complex ownership/management

Where the business is a sole proprietorship or closely held member managed partnership, this section may not apply.

- **Duty of Care**
  - Requires managers to act with the amount of care that an ordinarily careful and prudent person would use in similar circumstances, through diligence and discussion.
    - Question – Has duty of care been breached?
- **Duty of Loyalty**
  - Requires managers to act in good faith with the honest belief that their actions are in the best interests of the Company. Avoid self-dealing and place company interests first.
    - Question – Has duty of loyalty been breached?
- **Business Judgment Rule.** Applies in litigation to protect managers from fiduciary duty challenges, and considers whether the actions were in the best interest of the Company.
  - When a director has a personal interest in a transaction, the director's conduct is generally subject to enhanced scrutiny
- **State Law**. Small business owners should be mindful of distinctions between states

Small Business Condensed Debt Due Diligence

For financial distress issues relating to small businesses, it is prudent to do a debt due diligence review. For small businesses in particular, owners should have a meaningful discussion with an attorney and/or accountant to flesh out information that may be easily forgotten.

- **Assets / Liabilities**. First, identify (and value) assets and liabilities

Identify Business Assets, e.g.:	Identify Business Liabilities, e.g.:
• Equipment • Office furniture, decor and supplies • Vehicles • Security Deposits • Insurance Premiums • Below-market supply contracts • Customer lists • Intellectual property	• Commercial Lease Obligations • Customer orders • Supply orders • Notes Payable • Accounts Payable • Wages/Salaries Payable • Income Taxes Payable • Customer Deposits • Other Accrued Expenses Payable

Small Business Condensed Debt Due Diligence

- **Entity Organizational Documents** (review charter, bylaws, operating agreement, voting agreements, etc.)
  - Confirm who has authority to take actions
  - Confirm appropriate limitations of liability for non-corporate entities
- **Corporate Organization**
  - Review for applicable jurisdiction
  - Review capitalization of the company and list of security holders (if applicable)
  - Review for compliance with corporate formalities (e.g., separate bank accounts and accounting)
  - Identify management - officers/directors/managers
- **Review Commercial Agreements** (e.g., leases, suppliers, customers, equipment, etc.)
  - Confirm that agreements are between the third party and the business entity (rather than the business owner)
  - Confirm that signature pages reflect the same
  - Confirm there are no **personal** guarantees of business obligation
  - Confirm whether any creditors have security interests (e.g., equipment providers)
- ***Financial Reports.*** Review other financial reports relating to the business (tax filings, financial statements, etc.)
- ***Other Items.*** Consider other issues unique to the business after discussion with owner, e.g., litigation, employee matters, environmental matters, legal compliance, etc.

Determine Whether Bankruptcy May Be Appropriate

- Business owners need to write a business plan for a post-pandemic business world that consider:
  - How will the business operate?
  - Where will revenue come from?
  - What new expenses will be needed to turn the business around?

  *If a small business owner can write a business plan that shows a positive balance sheet after bankruptcy, restructuring might be a good option

- If a small business owner can't identify enough future revenue to pay off the debt, borrowing additional amounts may make matters worse
  - If a borrower can pay off creditors or negotiate a deal with them, they <u>don't</u> need to file for bankruptcy protection
  - If creditors won't negotiate a deal out of court, certain options in bankruptcy may allow borrowers to compel creditors to follow a negotiated plan where they get paid less than what is otherwise owed, and where borrowers can have some of their debt wiped out

- If a borrower is trying to restructure, a lawyer can work with them to negotiate with creditors and create a plan that avoids a bankruptcy
  - A borrower should be aware of how they might be personally liable for business debt they personally guaranteed

III. Access to Capital: Renegotiation, Refinancing & New Funding Sources

Refinancing or leverage for Renegotiating: Funding available to small businesses

For more information on funding available to a small business, please consider applying for Start Small Think Big services:

- Grants are the best option but may require multiple applications to maximize
- Loans are viable if projections suggest the business will be able to repay, not merely survive short term using the loan
  - Business owners should pay particular attention to the following:
  - Equity Financing (less likely for small/micro businesses)
  - Options for re-investing capital
  - Predatory lending (something to watch out for, especially when in distress)
  - Security and personal guarantees (something to avoid if at all possible)

Equity Partners: For Small Businesses

- **Equity financing raises funds for the company by selling equity in the company**
- **Small/Micro Businesses, especially in distress, are likely to focus on <u>friends and family</u>**
- **Questions to consider:**
  - In what stage of business is the company and what are its needs?
  - What is the small business owner willing to share with friends and family that have invested in the business?
    - Ownership? Voting rights? Decision-making?
  - Who will be the investors?
    - Family, friends
    - Networks – religious and community groups, entrepreneurial networks, financial advisors, angel investing networks (e.g., AngelList, Angel Investment Network)
  - How to finance?
    - Legally-binding contract; incremental or complete distribution
    - Equity crowdfunding platforms (e.g., Kickstarter or IndieGoGo)

Other Considerations

Reinvesting is primarily for those that are able to raise enough capital to refinance. Therefore, a small business owner needs additional capital that can be reinvested. It is best to grow revenue to service the new debt in the future without repeating the cycle. Borrowers should avoid predatory lending practices even when desperate.

Reinvesting Capital

- Small business owners who are able to raise sufficient capital should consider the following:
- Reinvest 30%-50% of profits and balance between various areas of the business
- **Options for reinvestment:**
  - **Marketing/Advertising**: Developing or redeveloping marketing strategy; upgrading website and servers
  - **Personnel**: New hires; reorganizing staff structure; trainings; benefits packages; improved business practices
  - **Assets/Equipment**: New purchases, restocking, repairs, maintenance

Predatory Lending

- Predatory lending relationships can leave borrowers with unstable credit and unmanageable debt, making repayment of loans and borrowing from future lenders difficult
- **Borrowers should be aware of :**
  - **Inadequate or misleading information**: Borrowers should solicit as much information as they can from lenders and should consult with a lawyer or advisor in order to fully understand the terms of the proposed loan.
  - **Inflated interest rates, fees and charges**

Security and Personal Guarantees

- **A security interest (collateral) is a right the borrower gives the lender to take possession of assets owned by the borrower in the event the borrower defaults as a method of repayment**
  - Borrowers should be prepared to offer at least some collateral to lenders when preparing to receive a loan offer
- **Borrowers also have the option to provide a guarantee, either in the form of a personal guarantee or a guarantee by a third party (another individual, company or the government)**
  - ***Borrowers should be wary of personal guarantees***. If an individual guarantees a company's debt, that person will become personally liable/responsible for paying back the lender if the company is unable to pay the debt back
- NYS Senate Bill S8538 is currently pending in the New York State Senate. The bill would make the general obligations law and banking law applicable to small businesses, generally providing additional protections for small businesses that seek funding

IV. Restructuring & Bankruptcy for Distressed Small Businesses

Overview of Options for Distressed Businesses

After a thorough debt check, there are key options for businesses to consider when they may not be able to renegotiate and/or raise sufficient capital to refinance their liabilities based on the results of their debt check.

- Business owners that are struggling to pay their debts have two primary options:
  (1) **Restructure** (in or out of bankruptcy) or

  (2) **Wind Down** (*beyond the scope of this webinar*)

There are paths to address each of these options in bankruptcy court or *out-of-court* *(the best option for most small/micro businesses)*

- Bankruptcy
  - Reorganization is referred to as a Chapter 11 Case
  - Liquidation is referred to as a Chapter 7 Case (*beyond the scope of this webinar*)
  - Both state and federal laws apply
- **Reorganization is often the best option and can also be accomplished through direct engagement with creditors out of the court system**
- Liquidation can also occur out of court in accordance with state laws (*beyond the scope of today's webinar*)

Business Planning

Consider the following:

- What will the business look like after the company emerges from debt-restructuring/bankruptcy?
- Can debt-restructuring/bankruptcy fix the problems wrong with the company, or does the small business owner need to make other changes?
- Prior to making any decisions concerning the future of the business, the business owner should focus on four essential areas:

Category	Key Considerations
Liquidity	▪ Consider whether the business has enough liquidity to survive a bankruptcy process ▪ Properly assess length of restructuring to ensure adequate liquidity throughout
Essential Vendors & Business Partners	▪ Review and develop strategy to avoid/minimize disruption ▪ Stabilize vendor base/avoid unnecessary emotion by communicating with vendors/business partners
Customers	▪ Develop strategy to minimize sales impact/delayed collection of receivables ▪ Communication planning to mitigate rumors from competitors
Employees	▪ Avoid unnecessary conflict/drama with a timely and consistent communication plan

Out-of-Court Renegotiation

- Negotiate with key stakeholders and identify financing sources to secure adequate liquidity to support operations
  - It's worth hiring an attorney for this process, but reaching out to stakeholders over the phone and explaining the impact COVID-19 has had on the business to discuss a solution that works for both parties may be a viable option for obtaining some relief
  - Review and understand the contract to enable a proper negotiation with stakeholders
  - Prepare a checklist of desired outcomes from the negotiation
    - If it's a vendor, the checklist might include lower prices or a different payment schedule
    - For a landlord, this might mean renegotiating the lease on better terms
    - For a lender, the checklist might include new payment terms and an extension on the amount of time the business has to repay its loans
  - Be flexible in negotiations – understand that the counterparty has also been impacted by the virus, and might have their own requirements for a negotiated contract
  - To the extent possible, be transparent about the business's financial difficulties

Out-of-Court Renegotiation (Continued)

- **<u>Requirements to Complete</u>**:
  - Understand available collateral, cash needs, and the required cash expenditures
  - Identify potential lenders and conduct outreach
  - Determine company's liquidity need and negotiate financing with existing banks or third party capital providers

Bankruptcy Reorganization: Ch. 11, Subchapter V

- The Bankruptcy rules were recently revised to offer special features to small businesses
  - The rules initially only applied to small businesses having debts of no greater than $2,725,625 (both secured and unsecured)
  - This was codified as part of the **Small Business Reorganization Act** (the SBRA):
- Debt limit for debtor eligibility increased to $7,500,000 under the CARES Act[1]
- Both individuals and business entities (such as corporations or LLCs) are eligible to file as small business debtors under SBRA, but <u>**at least half**</u> of the debtor's total debt must come from business activity
  - Note that a person whose sole asset is a building is not an eligible small business debtor under the SBRA

1. After March 27, 2021, this reverts to the original cap of $2,725,62

Bankruptcy Reorganization: Ch. 11, Subchapter V
Key benefits of the SBRA

- **Simplified plan confirmation process.** Likelihood of confirmation so long as plan is fair and equitable
- **Time efficient.** No creditors' committee, unless Bankruptcy Court orders the appointment of one for cause
- **Cost efficient.** No U.S. Trustee fees and the debtor has an option to pay administrative expenses—such as legal, accounting and administrative fees over life of bankruptcy plan
- **Increased control.** Only a debtor can file a plan and the debtor has the flexibility to modify a chapter 11 plan anytime within 3 years after confirmation
- **Independent advice.** A Trustee is appointed to assist the debtor in negotiating a consensual plan of reorganization and facilitates the process.
  - Unlike a Chapter 7 filing, the Trustee does not take over the operations of the debtor

Bankruptcy Reorganization: Chapter 11
Other Considerations

- Debtor filing for relief under Subchapter V or Chapter 11 may not be able to receive any relief under the Paycheck Protection Program (PPP)
  - On April 24, 2020 the Small Business Association (the "SBA") clarified that applicants involved in a bankruptcy case are ineligible to receive a PPP loan
  - Lack of uniformity on this issue:
    - Some courts issue temporary restraining orders compelling the SBA to ignore the applicant's bankruptcy status
    - Some courts defer to the SBA's rules prohibiting the granting of PPP loans to debtors
    - Some courts have granted the debtor's request to dismiss the case for the purpose of pursuing PPP funding
- Release and exculpation for debtors, management, officers, and directors
  - If a business owner is personally liable for corporate debts, the owner remains liable for any personally guaranteed liabilities even following the businesses bankruptcy proceedings
    - Individuals may seek separate bankruptcy relief to discharge personal debts

Wage Earner Repayment Plan in Bankruptcy: Chapter 13

- Under Chapter 13 bankruptcy, a small business has the option of staying open and making smaller monthly payments to creditors
  - The individual would be filing Chapter 13, not the business – a sole proprietor is personally liable for business debts and are included in the bankruptcy filing
- Chapter 13 requires a smaller payment on the debt for three to five years and wipes out qualifying debt after completing a repayment plan
- As of April 2019, the current debt limitations to qualify for Chapter 13 are:
  - $1,257,850 of secured debt, and
  - $419,275 of unsecured debt
- A trustee is appointed who oversees the case and collects payments from the debtor or through payroll deduction; and pays creditors
  - A Chapter 13 debtor cannot take on any significant new debt without consulting the trustee
- Chapter 13 may be preferable for a small business owner when:
  - The owner wants to continue operating the business
  - There are sufficient funds to make monthly payments to creditors
  - The owner has a plan for how it will repay creditors, which will involve fixed monthly payments. Once all payments are made under the repayment plan, the debtor gets a discharge of all debts

Overview of In-Court and Out-of-Court Options

	In-Court Options			Out-of-Court Options	
	Chapter 11, Subchapter V best if the owner wants to remain in business	**Chapter 13** best for sole proprietors with a small amount of debt	**Chapter 7** best for businesses that cannot continue operations	**Renegotiation with Stakeholders**	**State Law Liquidation**
What It Is	Allows business owner to reorganize its debts and stay in business	For sole proprietors who wish to reorganize personal and business debts in a single case	Allows business owner to liquidate its assets and use that money to pay creditors	Allows the small business owner to negotiate contract changes or a settlement of existing claims without a bankruptcy filing	Allows business owner to dissolve business after notice to creditors and certain actions to wind down the company
Pros	Business owner remains in control of the company, subject to bankruptcy oversight, and the automatic stay is put in place to protect the business' assets	Debtors keep all property but must pay unsecured creditors an amount equal to value of the assets it could have sold, usually over 3-5 years	Chapter 7 Trustee appointed to liquidate the assets; automatic stay put in place so other creditors can't take assets or sue the business/owner; business owner also gets discharge of business debts	Owner remains in control of the business and can continue operating the business without any oversight from the court or the state	More discreet process and allows the small business owner to focus on the sale and the ongoing business operations, without the need to also be running a bankruptcy process
Cons	Expensive process that is unlikely to be beneficial to very small businesses	Must make monthly payments to the Trustee for 3-5 years, but unsecured debts will only be discharged after business owner finishes the repayment plan; remains on business owner's credit report for 7 years; significant negative impact on owner's personal credit	Business owner still in control of the business but all assets will be liquidated and used to pay off debts; employees terminated because the business no longer operating; remains on credit report for 10 years	Contract counterparties are not always willing to modify current arrangements or settle claims, and without the court oversight it might be difficult to prevent them from withholding business	While there is no court oversight, depending on the type of business, owners must notify creditors of the intent to dissolve, after which time they may file claims for any amounts owed.
Miscellaneous	Owner who signed personal guarantees still responsible for those debts and for paying sales tax and other taxes, employee-related obligations, including wages, and required insurance	If the business owner is a sole proprietor, they may be able to protect co-signers under Chapter 13	--	Business operations may be affected because stakeholders/lenders will know the company is in trouble before the potential bankruptcy filing or liquidation	Process differs by state and type of business entity (i.e. sole proprietor, partnership, corporation, etc).

V. Conclusion

Conclusion

- Recap of the presentation:
  - Overview of a small business owner's duties to the business
  - What documents/numbers a small business owner needs to review to complete a Debt Check and assess the financial health of the business – condensed debt due diligence
  - The main options for refinancing
  - Overview of restructuring and bankruptcy

Conclusion

- Key takeaways for next steps:

  - Restructuring and bankruptcy proceedings can open the door to litigation. Representation in bankruptcy proceedings and in litigation are beyond the scope of the session and of our work at Start Small Think Big - seek appropriate legal counsel for litigation issues
  - Focus on actionable next steps to improve the accuracy of your debt check, access capital if reasonably likely to refinance, and choose options that fit the scale the business as well as future plans and capacity

Questions?

Join us next time:

Small Business Liability, Compliance & Risk Mitigation in light of COVID-19

Thursday December 10, 2020 at 2 PM EST

Register at https://www.eventbrite.com/e/small-business-liability-compliance-risk-mitigation-in-light-of-covid-19-tickets-129096662593

Thank You