Financial Relief for Your Troubled Small Business Clients by A. Thomas DeWoskin

It's no secret that many small businesses are facing financial troubles these days, not only because of the COVID-19 pandemic, but also because of the rapid and unpredictable twists and turns of the current economy. This article will discuss, in two parts, the various ways in which a financially troubled business can seek financial relief, ranging from informal negotiations and state statutory remedies to filing a Chapter 11 reorganization bankruptcy case, so that attorneys can provide general assistance to their small business clients, or refer them to an insolvency attorney if appropriate.

Part I

Informal workouts

If a debtor is on good terms with its creditors, especially its primary lenders, it may be able to earn itself out of its financial troubles. The secured creditors, of course, must be treated with full respect for their security interests in the assets of the debtor. Unsecured suppliers of critical goods and services also must be treated with care, as their cooperation may be needed at some point in the future.

It is often useful for a debtor to obtain an appraisal of its assets, both real and personal, from well-respected appraisers experienced in their fields. The appraisal should value the assets at three levels: forced liquidation value, orderly liquidation value, and fair market value. These values will enable the debtor to intelligently discuss the likelihood of collection in different situations.

Another useful action would be to hire a consultant. Sometimes business owners cannot see opportunities for improvement which are right in front of them, simply

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because they think that the current practice works well. The consultant can help the owner review the company's operating procedures, cash flow procedures and pricing structure to look for opportunities to increase profitability.

The consultant also could prepare projections of future profitability for the company, based upon the opportunities which are discovered. Armed with the collateral valuations and projections, the owner can show the company's creditors a plan for solving its problems.[1] That is much more effective than simply asking for more time or engaging in stalling tactics.

Statutory remedies

1. Assignments for the Benefit of Creditors

An Assignment for the Benefit of Creditors ("ABC") involves the assignment, or transfer, of all of an individual's or company's assets to a third-party assignee, often in lieu of a formal Chapter 7 bankruptcy liquidation. The assignee, who holds legal and equitable title to the company's assets in trust by virtue of the assignment, acts as a fiduciary who is empowered to sell the debtor's assets and distribute the proceeds to the assignor's creditors pursuant to priorities established by state law.

Although Missouri also recognizes the validity of a common-law assignment, most ABCs are made pursuant to Missouri's current ABC statutes, found in Chapter 426, RSMo. Unfortunately, those statutes were written in 1909 and have not been meaningfully revised since 1939. As a result, the ABC remedy has rarely been used in recent years, especially after the more recent U.S. Bankruptcy Code and Missouri Commercial Receivership Act have been enacted.

The Missouri Bar's Commercial Law Committee has drafted a proposed replacement for the ancient Chapter 426, which corrects some of its deficiencies. Unfortunately, the proposal has been languishing in the state legislature since 2018. Perhaps it will be considered in 2021.[2]

An ABC is commenced when a person transfers either all assets or certain assets to an assignee. Acting as a fiduciary, the assignee liquidates the assets and distributes the proceeds *pro rata* to all of the assignor's creditors.

Creditors need not agree to the assignment, and there is no automatic stay prohibiting collection actions against the debtor as the statues currently are written. However, even though a creditor can proceed against an assigning debtor for payment of its claim, the debtor, having transferred away all interest in the assets assigned, has no remaining assets from which a creditor could satisfy claims.

There is no provision in Chapter 426 providing for the discharge of the debt of the debtor. As a result, the debtor remains liable for any deficiencies remaining after the assignee makes his distributions. Although this is not a problem for a statutory person (a corporation or LLC), it is for a natural person, who may continue to earn money and accumulate assets going forward.

Additionally, creditors who do not accept the outcome of the assignment may force the debtor into bankruptcy by filing an involuntary petition within 120 days after the assignee was appointed or took possession.[3]

Section 400.9-301(3), RSMo, grants an assignee the status of a hypothetical lien creditor from the time of the assignment, thus generally entitling the assignee to void unperfected security interests in the debtor's property, much the same way as the "strong arm" clause of the Bankruptcy Code[4] empowers the trustee or debtor in possession.

Although Chapter 426 is still used upon occasion, the 1978 enactment of the Bankruptcy Code[5] greatly increased the number of situations where a formal bankruptcy filing would be more favorable to either debtors or creditors, or both. Among the various advantages are the automatic stay; the ability to avoid and recover preferences and fraudulent conveyances for the benefit of creditors; the ability to discharge most debts; and many other specific powers and duties.

2. Missouri Receiverships

A receivership, which appears similar to an ABC on its face, is actually much more effective because it is a court proceeding in which the receiver, unlike an assignee, is under the control of (and is responsible only to) the appointing judge. The court generally enters a lengthy order appointing the receiver, which sets out the powers and duties of all parties. As with an ABC, the purpose of the receivership is to prevent the deterioration of the debtor's business and prepare it for liquidation.

Prior to 2016, this was the entire statutory guidance on Missouri receiverships: "The court … shall have power to appoint a receiver, whenever such appointment shall be deemed necessary, whose duty it shall be to keep and preserve any money or other thing deposited in court, … pending any legal or equitable proceeding concerning the same …"[6]

Obviously, the lack of a more robust statutory framework for a receiver to follow has caused problems in many receiverships. Due process, for instance, was one such problem. A creditor's attorney could approach the presiding judge *ex parte,* explain the necessity of filing a receivership immediately, and present the judge with a draconian proposed order which often ran roughshod over the debtor's rights.

The lack of a controlling statute has led to inconsistent appointment orders because each was unique. There was no standard list of each entity's powers and duties. This was especially problematic if there was real estate to be sold. Title companies were extremely concerned about insuring a transaction in the absence of a statute granting the judge power to approve a sale proposed by the receiver.

Additionally, there was no consistent reporting or distribution process. In some receiverships, there was no allowance for the recognition of priority claims which generally would be paid before the general claims. There was no standard mechanism for disposing of funds which could not be distributed, among other similar problems.

In the mid-2010s, the Commercial Law Committee of the Missouri Bar drafted a more comprehensive replacement of the current statute. The drafting committee included experienced debtors'- and creditors'-rights attorneys from across Missouri. There was input from courts, professors, bar associations, and title insurers. It required substantial effort from all concerned, and became effective in August 2016 as the Missouri Commercial Receivership Act (MCRA).

Although MCRA provides that the prior receivership statutes and judicial precedents remain effective, it also addressed many of their deficiencies. It provides specific enumerated grounds for the appointment of a receiver, and makes the process an independent cause of action, rather than limiting it to proceedings ancillary to the relief being sought in the primary matter. The receiver may employ professionals with court permission.

Notice to the debtor is now required before a receiver can be appointed, creating a more level playing field. This provides the parties with time to negotiate a solution, and the debtor an opportunity to limit the receiver's powers, file a bankruptcy, or take some other action.

MCRA provides a limited automatic stay, and specifically grants the receiver powers of sale, authority to exercise certain "strongarm" powers, power to assume or reject executory contracts, and to seek the recovery of fraudulent conveyances under the Missouri Uniform Fraudulent Transfers Act.[8] It also sets out distribution priorities. Notably, it does not grant the receiver authority to recover preferential transfers.

One other significant change – a debtor may file a voluntary receivership action. There may be times when a debtor wants to avoid some of the restrictions which would be imposed on a debtor in a bankruptcy case, so it may choose to file a voluntary receivership instead.

MCRA represents a much-needed improvement to Missouri's receivership statute, bringing the state into the modern era in this area.

Part II: Bankruptcy

If none of the options under Missouri state law, discussed in Part I, appear to meet your client's needs, it may be time to consider a formal bankruptcy filing under the U.S. Bankruptcy Code.

Forms of Bankruptcy Relief

Before getting into the details, I will make a suggestion. While you discuss the options with your client, you may need to build up the confidence of the owner(s). The business owner likely is upset, worried, and confused about the future. They may assume the business failure was a personal failure. (Maybe it was, but.) However, it is rare for a business to fail because of only one issue. If the owner is unduly self-critical, it is harder for the business to recover. Besides, bankruptcy may provide a chance to fix what went wrong.

Also, the owner may find solace in the fact that the old stigma of filing a bankruptcy case has largely dissipated over the past few decades. Our Founding Fathers realized that the traditional European use of a debtors' prison was unworkable and that a structured mechanism to help financially strapped people and businesses navigate a "soft landing" was needed instead. Thus, there is a provision in the Constitution requiring the Congress to make "uniform Laws on the subject of Bankruptcies throughout the United States."[9]

If your client feels embarrassed about filing bankruptcy, they really should not. Compare it to taking a tax deduction (another example of statutory relief provided to individuals and to business). It's there for you to use, so there's no reason to feel guilty for doing so.

The Bankruptcy Code provides for several different types of bankruptcy filings:[10]

Chapter 7 – A liquidating bankruptcy case, available to almost all persons.

Chapter 9 – Specific provisions for municipalities, or subdivisions thereof.

Chapter 11 – A reorganization case, available to almost all persons.

Chapter 12 – Special reorganization provisions for family farmers.

Chapter 13 – A limited reorganization, available only to natural persons and subject to certain income and debt limitations.

There are two aspects to bankruptcy relief which are common among all the chapters – the automatic stay[11] and the opportunity for a fresh start.[12]

The remainder of this article will discuss only Chapters 7,11, and 13. The other two chapters are infrequently used and are too specific for a general discussion. Chapters 1, 3, and 5 of the code contain provisions applicable to all five types of cases.

Chapter 7: Liquidation

When most people hear the word "bankruptcy," they think of a liquidation. A trustee is appointed in every case. The trustee's primary duty is to determine if the debtor has any assets which can be liquidated,[13] and then to distribute the liquidation proceeds to creditors pursuant to the priorities set forth in the code.

Contrary to popular misconception, a debtor does not "lose" all assets to the trustee. The Trustee is interested only in assets which have sufficient value to make liquidation worthwhile. Thus, the trustee would not liquidate the debtor's home if it were worth $250,000 but had a $260,000 mortgage against it. (However, if the debtor could not afford to continue making the payments on the mortgage, the house still could be lost, not to the trustee, but to foreclosure.)

Only natural persons are entitled to receive a discharge of their debts, unless they are hiding assets, refusing to cooperate with the trustee, or otherwise not playing by the rules. Some debtors may not qualify for a Chapter 7 case based on a "means test"[14] to determine if the debtor's income exceeds certain limitations. Such debtors may be able to file under Chapter 11 or 13 instead. Corporate entities do not receive a discharge, which is why there are very few Chapter 7 business filings.

Not all debts can be discharged in a Chapter 7 case, however. Domestic Support Obligations,[15] debts incurred by fraud, many taxes, and several other enumerated types of debts are nondischargeable.[16]

Chapter 11: Reorganization

Another option for a small business is a Chapter 11 reorganization. Generally, small businesses shy away from Chapter 11, because it is expensive, risky, time-consuming, and complex. Chapter 11 is the only bankruptcy option, however, for a small business seeking to restructure and continue in operation if it is not a sole proprietorship.

Cases filed under Chapter 11 generally seek to reorganize the debts of the debtor, although liquidations in Chapter 11 are not uncommon. In a Chapter 11 case, the debtor generally remains in possession of its pre-petition assets (as "debtor in possession" or "DIP") and uses them to continue operating its business as it reorganizes. Relief under Chapter 11 is available to both natural and artificial persons.

Chapter 11 cases often require a number of issues to be resolved promptly, so the petition commencing the case often is accompanied by a number of "first-day" motions which seek relief on an expedited basis regarding various issues. These issues can be procedural, such as the employment of professionals, requests to continue utilizing prepetition banking systems, and requests to set procedural guidelines for the case.

First day motions often seek substantive relief as well. Several commonly filed substantive motions would include the debtor's motions to use its assets in the ordinary course of business while the case is pending, to seek post-petition financing, and to pay its employees.

The power of the DIP to continue utilizing its assets must be tempered with a recognition of each secured creditor's interest in those assets. The creditor is entitled to protection of those interests and compensation for any deterioration of its interest in its collateral while the case is pending.

The Bankruptcy Code provides that a secured creditor's interests may be protected by requiring the debtor to provide "adequate protection"[17] in the form of an "indubitable equivalent" of its interests, such as cash payments to the creditor and providing a replacement lien on property acquired post-petition. Other forms of adequate protection include maintaining and insuring the collateral and appropriate reporting requirements.

The Bankruptcy Code provides a "ladder" of financing options for the debtor, with increasing more serious protection for the existing creditors.[18] Debtors may obtain credit in the ordinary course of business. The debtor may also incur debt outside of the ordinary course, but only with authorization from the bankruptcy court. Both types of obligations are deemed "administrative expenses,"[19] which are entitled to priority in payment.

If the debtor is unable to obtain unsecured credit, the court may authorize it to obtain secured credit, with priority over administrative expenses, and secured by junior liens upon property which is already encumbered, or senior liens upon unencumbered assets.

Finally, if the debtor is unable to borrow under the terms above, the court may authorize the new obligation to be secured by an equal, or even senior, lien on property which is already encumbered.

The general rule in a Chapter 11 case is that the debtor may not pay any prepetition debts while the case is pending. Courts often grant exceptions to allow for paying employees and all related payroll taxes, to honor pre-petition customer deposits, or to pay "Critical Vendors," which are owed money for pre-petition goods and services, will not continue to supply them without being paid, and whose goods are services are necessary to the Debtor's operations and not readily available elsewhere.

The primary goal of every Chapter 11 debtor is to develop a Plan of Reorganization which allows it to restructure its debts and remain in business. This may or may not include the sale of unprofitable divisions or the sale of unnecessary equipment. A debtor may reject burdensome leases (of real or personal property) and pay the lessor pennies on the dollar.[20]

The debtor can reorganize its obligations to secured creditors in two very important ways. First, if the creditor is under-secured (*i.e.,* the value of its collateral is less than the debt owed to the creditor), the debtor can split the creditor's claim into two different claims – the secured portion (*i.e.,* the value of the collateral) and an unsecured portion (the remaining balance due). The unsecured portion is lumped with all the other unsecured claims and paid at pennies on the dollar.

Then, the debtor can alter the terms under which the secured debt is repaid, including the interest rate, and the timing, amount, and duration of the payments. It is not uncommon for secured claims to be repaid under these more favorable terms for several years, after which the remaining balance comes due in a "balloon" payment. Lenders often are more willing to accept a shorter-term arrangement than something which binds them for many years.

The debtor is required to sort its creditors into "classes" of claims. Each creditor in a class must be similarly treated in the plan. The plan is sent to the creditors entitled to vote to accept or reject the plan. A class of creditors has accepted the plan if creditors holding at least two-thirds in amount and more than one-half in number of the creditors in that class have voted in favor of the plan.[21]

There are other statutory requirements for confirmation, which the judge must rule upon during a hearing to consider confirmation.[22]

If confirmed, the plan acts as a new contract between the debtor and its creditors, replacing whatever arrangements existed prior to confirmation. Its terms are binding on all creditors, whether they voted for the plan or not.

Special Small Business Provisions

The Coronavirus Aid, Relief and Economic Security Act of 2020 ("CARES Act"), together with the Small Business Reorganization Act of 2019 (the "SBRA"), both of which became effective in 2020, include provisions designed to make a small business debtor's trip through Chapter 11 less burdensome and therefore more attractive to them.

The term Small Business Debtor is defined in the Bankruptcy Code[23] to include persons engaged in business (other than debtors whose primary is owning or operating real estate).The CARES Act increased the debt ceiling to be considered a small business debtor, from the previous $2,725,625 in total debt to $7,500,000, in order to increase its availability to slightly larger businesses.[24]

As with so many 'improvements,' the are costs and benefits to the election to be treated as a small business debtor.

- Although only the debtor is permitted to file a Plan, it must do so quickly – within 90 days of filing the case.
- Although there will be no creditors' committee, a trustee will be appointed to oversee the case. Although the debtor is required to pay the trustee's fees, one who knows the ins and outs of Chapter 11 could be of great value to the debtor.
- A Chapter 11 plan can be confirmed without the support of any class if certain other conditions are met.
- The ability of the debtor to recover preferential transfers has been limited. In addition to venue changes, and the debtor now is required to exercise certain due diligence prior to filing the lawsuit. Clearly, this is an improvement for creditors rather than debtors.

The primary benefit of the new provisions may turn out to be the mandatory appointment of an overseeing Trustee. Because no creditors' committee is appointed in a small business case, the trustee represents the opportunity for "approval" of the debtor's progress and its Plan of Reorganization, and serve as a reliable source of information for the judge at status conferences or hearings.

Chapter 13 "Wage-Earner" Plan

If the business has failed, the owner may need relief from personal guarantees and other leftovers from the business. A Chapter 13 filing may help. Not all natural persons may file a Chapter 13, as it is meant more for the average person rather than the super-rich with super-sized debts.[25]

A Chapter 13 is not a liquidating case. Rather, the debtor proposes a Chapter 13 plan which deals with all debts.[26] The Plan runs for three to five years, and the debtor is required to make periodic payments to the Chapter 13 Trustee, who distributes the funds to creditors. The debtor is required to commit all of his future income (or such part as may be necessary) to fulfilling the terms of the plan.

There is a confirmation hearing, as in Chapter 11, at which time the plan is confirmed or denied if it does not comply will all statutory requirements.[27] Then, if the plan is successfully concluded, the debtor receives a discharge, which is somewhat broader than under Chapter 7, as certain debts which are not dischargeable in a Chapter 7 case can be discharged in Chapter 13. There also are provisions for a limited "hardship" discharge if the debtor cannot fully perform the obligations required by the Plan.[28]

One last note: the calculation of how much income a Chapter 13 debtor has available to pay under the plan is not based on reality. The Code mandates that you start with the debtor's actual income and then subtract the Internal Revenue Service's "standard expenses" for residents of the county in which the debtor resides. The resulting number is the dollar amount the debtor can statutorily afford to pay.

Of course, unless the debtor has a very low income, that number generally is larger than what the debtor can actually afford to pay. This has the effect of denying individuals for whom Chapter 13 would be the perfect sort of relief from access to that relief.

Conclusion

Common law, state law, and federal law all provide some form of assistance to the financially troubled small business. With the information contained in this article, you will be able to counsel your client generally and refer them to an insolvency attorney if needed.[29] ⚜

1 These are useful steps to take while preparing for a bankruptcy filing as well.
2 The proposed amendment can be found at 2020 Missouri House Bill No. 2277, Missouri One-Hundredth General Assembly, Second Regular Session 2020 MO H.B. 2277.
3 11 U.S.C. § 303(b) sets out the requirements for filing an involuntary bankruptcy case.
4 11 U.S.C. § 544.
5 11 U.S.C. §§ 101 *et seq.,* replacing the Bankruptcy Act of 1898.
6 § 515.240, RSMo 1939.
7 § 515.500 *et seq.,* RSMo.
8 § 515.545(1)(6), RSMo. Missouri's fraudulent conveyance statute can be found in Chapter 28, RSMo.
9 U.S. Const. art. I, § 8.
10 The limitations on who may be a debtor under each chapter may be found at 11 U.S.C. § 109. Additionally, a debtor who is a natural person must pass a "means test" to qualify for a Chapter 7 case, the details of which are set out at 11 U.S.C. § 707(b).
11 11 U.S.C. § 362.
12 *Local Loan Co. v. Hunt,* 292 U.S. 234, 244 (1934)
13 Not all property is available to the Trustee for liquidation. Missouri has chosen for its statutory exemptions to be used in lieu of the exemptions provided in the Code. § 513.427, RSMo. Most common household assets are exempt under Missouri statute, and other assets never become part of the bankruptcy estate. Property owned by wife and husband as tenants by the entirety is the primary example of this. With certain exceptions, if a married debtor files bankruptcy and the spouse doesn't, property held as tenants by the entirety is not available to the Trustee for liquidation in Missouri. The tenants by the entirety laws in Illinois are quite different. Most Missouri exemptions can be found at § 513.430 *et seq.,* RSMo, although there are others scattered throughout the Missouri statutes.
14 11 U.S.C. § 707(b).
15 A Domestic Support Obligation ("DSO") is defined in 11 U.S.C. § 101(14A) as an obligation owed to "a spouse, former spouse, or child of the debtor or such child's parent…" which is "in the nature of alimony, maintenance, or support."
16 Most types of non-dischargeable debts are set out at 11 U.S.C. § 523.
17 Adequate protection is defined at 11 U.S.C. § 361.
18 11 U.S.C. § 364.
19 Types of administrative expenses can be found in 11 U.S.C. § 503(b)(1).
20 Moreover, the landlord's claim is limited under 11 U.S.C. § 502(b)(6) to the remaining rent due under the lease up to one year, or 15% of the remaining term of the lease not to exceed three years.
21 11 U.S.C. § 1126.
22 Those requirements can be found in 11 U.S.C. § 1129.
23 11 U.S.C. § 101(51D).
24 This increase sunsets in March 2021 unless Congress acts to keep it in place.
25 11 U.S.C. § 109(e). The permissible debt levels are adjusted every three years. and are set currently at $419,275 in secured debt and $1,257,850 in unsecured debt.
26 The required and optional provisions for a Chapter 13 Plan are set out at 11 U.S.C. § 1322.
27 Confirmation requirements are set out at 11 U.S.C. § 1325.
28 Compare the Chapter 13 discharge described at 11 U.S.C. § 1328 with the Chapter 17 discharge at 11 U.S.C. § 727.
29 You're entitled to a free additional tip for actually reading the endnotes. Stress the need for your clients to consult with you sooner rather than later, so that the business still has some assets to work with, including the goodwill of its creditors. If the client waits until the bitter end to seek help, it may be too late to do anything useful.