ProfitGuard
Know The Risk *Before* You Ship

The Credit View

Newsletter

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BEWARE OF SUBCHAPTER V

Created in 2019 by the Small Business Reorganization Act, Subchapter V of Chapter 11 of the Bankruptcy Code provides faster, easier, and cheaper alternatives for small businesses to reorganize their debt. Subchapter V puts business owners in the driver's seat by allowing them to maintain control and keep their equity. Along with this, it also makes them the only party who can submit a restructuring plan, while also facing no objections from a creditors' committee. As opposed to a Chapter 11 bankruptcy where a reorganization plan must be approved by other parties, Subchapter V grants the court the authority to confirm a business plan, even if creditors do not agree. As such, it places a larger burden on creditors to collect debt.

To be eligible for Subchapter V, a business must meet certain requirements, including:

- Having less than $7.5 million in debt
- Having 50% of business debt coming from business activities
- Being a "for profit" business

Small business filings, captured as Subchapter V elections within Chapter 11, increased 61% to 153 in July 2023, up from 95 in July 2022. Small business filings, captured as Subchapter V elections within Chapter 11, totaled 814 in the first six months of 2023, a 55% increase from the 525 elections during the same period in 2022.

It is important to note that the substantial year-over-year increase in Subchapter V elections reflects statutory developments that took place last year. The Bankruptcy Threshold Adjustment and Technical Corrections Act was quickly enacted in June 2022 to restore the debt eligibility limit for small businesses back to $7.5 million (up from $2.7 million). The increased eligibility limit is currently set to sunset on June 21, 2024.

While these eligibility requirements remain through mid-2024, it's important for credit managers to know what percent of their customer portfolio is made up of businesses that could file using Subchapter V. As explained by Jason Torf of Tucker Ellis LLP, "You might even consider placing eligible customers in a higher risk category. There is an additional layer of risk with Subchapter V that does not exist in the traditional Chapter 11 route, and debt recovery is not as successful." As mentioned earlier, a creditors' committee is not automatically appointed in Subchapter V and is instead only appointed upon a "showing of cause." An unsecured creditors' committee wields a great deal of power and may be able to delay or even prevent a plan confirmation if they feel they aren't getting the best deal. However, in Subchapter V, the goal is to decrease the costs. When a creditor committee is formed in a Chapter 11 case, the committee can hire its own professionals, however, the debtor is required to pay for the fees and costs of the committee's professionals.

Subchapter V cases also go beyond other Chapter 11 cases by allowing for relaxed plan confirmation requirements. Plans can be confirmed as long as they do not discriminate unfairly and are fair and equitable with respect to each class of claims or interests. This is under the condition that all projected disposable income of the debtor is paid into the plan for a three-to-five-year period. This is another hurdle for creditors, as many Subchapter V cases show substantial payments in terms of bonuses and compensation to insiders, which artificially decreases disposable income. Jason Torf adds, "It can incentivize debtors to put forth projections in its plan that minimize its disposable income so they can pay the least amount possible to creditors. If the debtor exceeds its income projection, the debtor gets to keep that money."

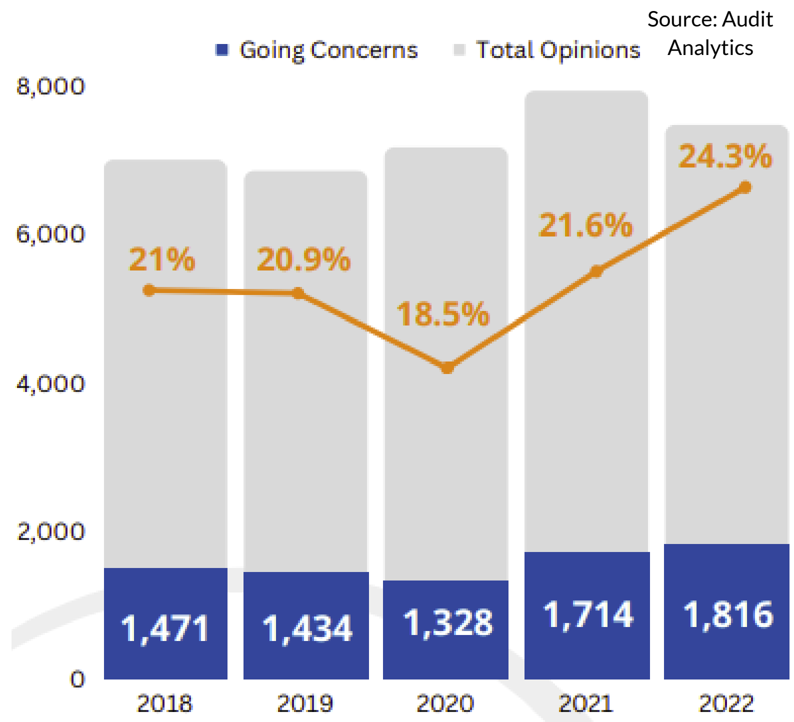
To summarize, Subchapter V is a streamlined and cost-effective alternative to traditional Chapter 11 bankruptcy designed specifically for small businesses. At the same time, it can severely limit a creditors' debt collection efforts and strip away certain elements that are beneficial to creditors. With that said, it is important to understand the increased risk factors associated with Subchapter V.

AUDITOR 'GOING CONCERN' WARNINGS TICK UP

A going concern warning is a statement issued by a company's management, auditors, or both, when they believe that there is a significant chance that the company will not be able to pay its debts or meet its financial covenants within the next 12 months. This warning is issued when there are conditions or events that raise substantial doubt about the company's ability to continue as a going concern.

Some experts suggest 'significant chance' equates to likely and implies "a greater probability than 51%, probably closer to a range of 70% to 80% that it will happen." When securing confidential information from your customers, it is always best to ask for audited financial statements for this reason.

In the United States, going concern opinions grew to 24.3% in FY2022 from 21.6% in FY2021, despite a decrease in total opinions issued. In Canada, the number of companies that received a going concern increased by 3.5% during FY2022, leading to a going concern rate of 57%. This spike between FY2021 and FY2022 is the highest going concern rate increase over the ten-year period in Canada. This data is according to an Audit Analytics report that analyzed annual reports for public companies as well as foreign companies that file reports with regulators. The number of U.S. companies that received a new going concern in FY2022 increased to 535, the highest amount seen since FY2008. While Audit Analytics only tracks public companies, we are seeing increases in the private sector as well.



Following this pattern of increased warnings, bankruptcies continue to grow, with more companies filing for Chapter 11 in the first half of this year than in any year since 2010, according to S&P Global. More distressed businesses are turning to the financial lifeline of bankruptcy.

Defining Substantial Doubt

Substantial doubt exists when relevant conditions and events indicate that it's probable that the company won't be able to meet its current obligations as they become due. Examples could include:

- Recurring losses
- Debt defaults
- Working capital deficiencies
- Legal items/lawsuits
- Loss of key customer or supplier

Although a going concern warning is a serious red flag, it does not always mean the company will file for bankruptcy in the near term. The company may be able to negotiate with its creditors, refinance a loan, get a capital infusion, or use a different strategy to resolve the issue at hand. That said, it is still best practice to flag a going concern business and put it into a high-risk category. You will want to speak with company management right away to obtain additional information that addresses the issues mentioned in the audit. The account should also be monitored closely, securing regular financial, management discussion and analysis (MD&A), and liquidity data.

3 TIPS TO MINIMIZE CREDIT RISK RIGHT NOW

Managing credit risk is a complex and challenging task, even in the best of times. While it has never been an exact science, the current economic environment is making it increasingly difficult to stay ahead of the curve. Tightening lender standards, elevated interest rates, and refinancing risks, along with economic volatility, are all contributing to a more uncertain credit landscape.

In this article, we will discuss three important steps that can be taken to improve credit risk management practices. Decision makers who implement these steps will likely be better equipped to navigate the uncertainty and develop a deeper understanding of the factors shaping credit quality over time.

1 Check Your Customer's Credit History

Step one is to confirm whether your prospective customer is creditworthy. We advise requesting the following details from your customer when setting up a new credit file:

Corporate information: This includes the company's legal name, trade name(s), headquarters address, and contact information for the person responsible for purchasing and payment.

Bank information: Primary bank and contact information. You should secure a bank reference including loan borrowing size, current availability, maturity date, and whether the customer is in compliance with their covenants. We recommend updating this liquidity information every six months.

Commercial trade references: This includes the names of at least three of their suppliers. We then advise you to contact them and secure a reference that includes the average credit balance carried, average high credit over the past year, and payment behavior in days beyond term, along with how long they have done business with the customer.

Financial statements: If you can secure this data, we recommend sourcing the annual audited statements at a minimum. Ideally, you should source interim data as well. For public customers, you may find their quarterly and annual results online.

2 Periodic Credit Reviews

Once a customer is onboarded and assigned a credit limit, this is not something to set and forget. As a best practice, a formal review and update of each customer credit file should be completed at least twice a year. The frequency may increase if:

- **The customer asks for an increased credit limit**
- **The customer asks for a change in payment terms**
- **The customer's ownership has changed**
- **The customer's payment habits have changed**
- **You have not extended credit to this customer in the past 12 months**

3 Have a Plan to Deal with Bad Debt

Unfortunately, late payments are a fact of life for businesses of all sizes. When it comes to staying ahead of bad debt, what strategies should you apply to ensure that outstanding debt is recovered in the most time and cost-effective way? Follow some of these common collection processes to increase your chances of getting paid.

Act early: The longer you wait before following up with a customer, the lower the likelihood of collecting. According to reports, the probability of collecting an account 90 days past due drops to just 69.6%. At six months past due, there is only a 52.1% chance of collection. If the account ages to one year past due, the likelihood of a successful collection is 22.8%.

Use phone calls to back up collection letters: Collection letters work better when combined with phone calls. It is crucial to call and follow up promptly if a promised payment is not received.

Talk to someone in charge: When you call, make sure you're speaking with someone who has the authority to issue payment.

Be understanding but firm: You can empathize with your late-paying customers, but make it clear, without being abusive, that you expect to be paid as soon as possible. Always ask for a specific date for when you can expect to receive payment, remind them of your payment terms and say that you will call if you haven't received payment by the promised date.

Involve a collection agency: If you've exhausted all other options, you may need to involve a collection agency. This is typically a last resort and can be costly, but collection agencies are powerful tools for getting paid. We also note this can strain your relationship with the customer, because it can affect their credit rating.

Don't ship until the customer's account is current: If you're shipping goods to the customer on credit, you may need to consider suspending future shipments until the outstanding balance is paid in full.

Keep good records of all correspondence with the customer, including invoices, payment reminders, and phone calls. Document any attempts you make to collect the payment, such as the date and time of the call, who you spoke to, and what was said.

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