WHITE PAPER

SUBCHAPTER V:
Essential Insights for Credit Professionals

- Subchapter V makes Chapter 11 more attractive to the "small business" debtors that are eligible to file under Subchapter V, but in many respects do so at the expense of unsecured trade creditors. While Subchapter V provides small business debtors with most (if not all) of the same benefits of a "traditional" Chapter 11 filing, it strips away certain elements of traditional Chapter 11 that benefit unsecured trade creditors.

- Small business filings under Subchapter V dropped by 45% from June to July 2024 due to the reversion of the temporarily enhanced debt limit from $7.5 million to $3,024,725.

- While Subchapter V has been praised for its efficiency, there are concerns over whether it truly facilitates successful reorganizations or merely delays inevitable failures.

- Among the key differences between a traditional Chapter 11 and Subchapter V case that impact unsecured trade creditors are: the lack of a creditors' committee in Subchapter V (without a creditors' committee, trade creditors lose a platform for collective representation, influence over the reorganization process, and ability to investigate actions that may increase creditor recoveries); and the ability for the Subchapter V debtor to stretch out payment of administrative expense claims (e.g., claims for goods sold to the Debtor on credit during the bankruptcy case) over the three- to five-year life of the plan.

- It's key for unsecured trade creditors to stay informed and proactive in Subchapter V cases to effectively protect their interests.

OVERVIEW

With the Small Business Reorganization Act (SBRA) that went into effect on February 19, 2020, Congress amended the Bankruptcy Code to create a new subchapter to Chapter 11 for the reorganization of small business debtors. Unlike the existing small business provisions under Chapter 11, Subchapter V offers an alternative path that small businesses can elect to follow when filing for bankruptcy. This new subchapter was designed to address the unique challenges that small businesses face in traditional Chapter 11 cases, such as high costs, lengthy timelines and stringent requirements that often make reorganization unattainable.

Despite its benefits, Subchapter V also raises concerns. While it has been praised for its success in streamlining the bankruptcy process, questions remain about whether it truly leads to successful reorganizations or merely postpones inevitable business failures—with unsecured trade creditors paying the price.

This white paper will explore these issues in depth, examining the practical implications of Subchapter V for B2B trade creditors, who must navigate this new landscape while managing the risks associated with small business bankruptcies.

CONTENTS

4 Understanding Subchapter V

5 Does Subchapter V Work?

6 Traditional Chapter 11 vs Subchapter V

8 Impact on Trade Creditors

10 Risk Mitigation Strategies

12 Case Studies

14 Recommendations/Credit Professionals Respond

15 What's Next

UNDERSTANDING SUBCHAPTER V

The SBRA did not repeal the previously existing small business debtor provisions of Chapter 11, but instead created an alternative process under Subchapter V that small business debtors may opt into through an election on the Chapter 11 petition.

What is a small business debtor? A small business debtor is one engaged in commercial or business activities that has aggregate non-insider, non-affiliate, non-contingent liquidated secured and unsecured debts, as of the date of the commencement of the bankruptcy, of no more than $3,024,725 (subject to increase for inflation every three years), with at least half of the debt arising from the commercial or business activities of the debtor.

In March 2020—shortly after Subchapter V's enactment—the maximum debt threshold was temporarily increased to $7.5 million, resulting in a tidal wave of Subchapter V filings over the first four years of its existence. Subchapter V filings have decreased significantly since the temporary debt threshold sunset and reverted to $3,024,725 on June 21, 2024. However, many bankruptcy professionals anticipate that Congress will eventually increase the debt threshold and make Subchapter V more prominent again.

The purpose of Subchapter V is to provide a Chapter 11 process that is more attractive and accessible for small businesses, since the requirements and costs associated with a "traditional" Chapter 11 make that process untenable for many small businesses. The Subchapter V process is intended to be more expedited, streamlined and cost-effective than a traditional Chapter 11 process.

Subchapter V also provides a path for equity holders to retain their interests without meeting the otherwise stringent requirements of doing so in a traditional Chapter 11, such as satisfying the absolute priority rule (e.g., paying all classes of claims in full or providing a "new value" contribution toward the Chapter 11 plan). Altogether, this makes for a bankruptcy process more appealing to small business owners.

DOES SUBCHAPTER V WORK?

Trade creditors are the lifeblood of our economy, currently providing approximately $5.6 trillion in capital to businesses in the United States, most of which is extended on an unsecured basis. Prior to Subchapter V, many small businesses were resorting to state court receiverships, assignments for the benefit of creditors (ABC), UCC Article 9 sales or just going out of business because bankruptcy was too expensive, slow and not accommodating to small business owners. Subchapter V bankruptcy was an effort to get around those problems.

Subchapter V has been lauded by its proponents in the bankruptcy and restructuring industry as a massive success, since its streamlined and cost-cutting procedures have led to a significant amount of Subchapter V filings with plans being confirmed in most of them. Indeed, in 2023, 45% of all debtors that filed Chapter 11 cases used Subchapter V. Although there were only 171 small business filings in July 2024 (a 45% drop from June's record total of 308), that drop-off was due to the fact that fewer companies were eligible to file under Subchapter V after the maximum debt threshold dropped to $3,024,725 (and, despite the reversion of the debt threshold, Subchapter V filings were up 5% YoY in August 2024 vs. August 2023, and up 9% YoY in September 2024 vs. September 2023, per Epiq). Bankruptcy professionals have been lobbying Congress to increase the maximum debt threshold to $7.5 million again, in light of the apparent success of Subchapter V.

However, given the Subchapter V debtor may stretch payments of administrative expense claims and confirm a plan without any impaired consenting class (while equity holders retain their interests), it is unclear whether Subchapter V truly lends itself to a successful reorganization, as opposed to the debtor simply "kicking the can down the road." In other words, confirmation of a plan may not be the best barometer for "success" when evaluating Subchapter V cases; a better barometer would be the success of the plan itself—i.e., whether the debtor timely makes all its payments under the confirmed plan and the business survives thereafter.

According to an *eNews* poll, 22% of credit managers polled found that most small businesses that file under Subchapter V have successfully reorganized and 35% found that some have been successful. Conversely, 25% say that these filings have been minimally successful, and 18% found that most, if not all, have failed to reorganize.

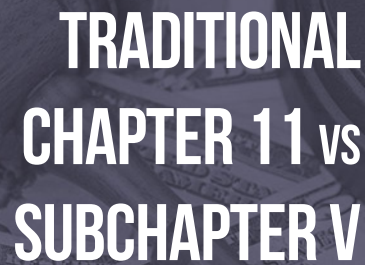
HOW SUCCESSFUL HAVE SUBCHAPTER V REORGANIZATIONS BEEN FOR YOUR CUSTOMERS?

22% Most have completed reorganization.

35% Some have completed reorganization.

25% Few have completed reorganization.

18% Most or all have failed to reorganize.



TRADITIONAL CHAPTER 11 VS SUBCHAPTER V

A primary concern of trade creditors is the inherent imbalance created by Subchapter V of the Bankruptcy Code. Subchapter V allows small businesses to avail themselves of substantially all of the benefits of (and in several instances, greater benefits than) a traditional Chapter 11 case through an extremely expedited process at a minimal cost to the debtor. However, the creditors who bear the burden of those benefits are left without the most significant protections of Chapter 11 and, to protect their interests, would have to incur the same, or even more, of the costs.

1. **Elimination of creditors' committee:** Unlike traditional Chapter 11, a creditors' committee is not automatically appointed in Subchapter V cases. This can save the debtor significant costs and reduce potential objections.
2. **Appointment of trustee:** A Subchapter V trustee oversees the case and monitors the debtor's progress, although they lack certain powers and economic incentives compared to a creditors' committee.
3. **No U.S. Trustee fees:** Subchapter V debtors are exempt from paying quarterly fees to the U.S. Trustee, resulting in significant savings.
4. **True exclusivity:** Only the debtor can file a plan in Subchapter V, unlike traditional Chapter 11 where non-debtors may file after 120 days.
5. **Expedited timeline:** Debtors must file a plan within 90 days of the petition date, speeding up the process.
6. **No disclosure statement required:** Subchapter V eliminates the need for a separate disclosure statement, streamlining the plan confirmation process.
7. **Less strict confirmation requirements:** Subchapter V allows for the confirmation of a nonconsensual plan without needing an impaired consenting class. A Subchapter V plan can be confirmed without adhering to the absolute priority rule with respect to general unsecured claims (as discussed below), if the plan is deemed "fair and equitable" and provides for the debtor's disposable income to be applied to payments over three to five years.
    - To be "fair and equitable," a Subchapter V plan must meet the following requirements: (1) the debtor will be able to make all payments under the plan; (2) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and (3) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made. (11 U.S.C. § 1191(c)(3)(A)-(B)(ii)).

- In addition, with respect to a class of secured claims, the plan must satisfy Section 1129(b)(2)(A), much like a traditional Chapter 11. (11 U.S.C. § 1191(c)(1)). However, with respect to non-priority general unsecured claims, the plan is "fair and equitable" so long as either: (1) all of the debtor's projected disposable income to be received in the three-year period (or up to five-year period, if the court directs) of the plan will be applied to make payments under the plan, or (2) the value of the property to be distributed under the plan during such period is not less than the debtor's projected disposable income. (11 U.S.C. § 1191(c)(2)(A)-(B)).
- This is a critical deviation from traditional Chapter 11, because it means that the absolute priority rule in traditional Chapter 11 is eliminated with respect to general unsecured creditors in Subchapter V cases—that is, equity holders may retain their interests under a confirmed Subchapter V plan, even if all classes of creditors are not paid in full and no new value is provided by the equity holder, so long as the debtor's projected disposable income is paid to creditors over the life of the plan.

8. **Payment plans:** In addition, Section 1191(e) of Subchapter V provides that administrative expenses and certain priority claims may be deferred and paid in installments during the term of the plan.
9. **No absolute priority rule benefiting general unsecured creditors:** The typical requirement in Chapter 11 bankruptcies, which mandates that general unsecured creditors must be fully paid before equity holders can maintain their equity, does not apply.
10. **Cramdown provision:** Subchapter V further specifies that a plan is "fair and equitable" if the debtor is providing all their "projected disposable income" (or its value) to fund plan payments over the three-to-five-year life of the plan.
11. **Non-dischargeability:** If a debt is deemed non-dischargeable, the debtor is still obligated to repay it, even after the bankruptcy process is completed. If a debtor company provided false financial information to secure credit, the creditor may have the power to block the discharge of that debt under bankruptcy.

IMPACT ON TRADE CREDITORS

Subchapter V places a larger burden on creditors to collect debt because it strips away certain elements of a traditional Chapter 11 that are beneficial to creditors. Here are just a few examples of how Subchapter V impacts B2B credit professionals:

1. **Elimination of creditors' committee:**
   Without a creditors' committee, credit professionals lose a platform for collective representation and influence over the reorganization process. The absence of a committee means less oversight, no investigation into prepetition liens or potential causes of action against insiders and third parties, and fewer objections to unfavorable terms in the reorganization plan—all of which may adversely affect creditors' recovery prospects.
2. **Appointment of trustee:**
   The appointment of a Subchapter V trustee introduces a neutral party responsible for overseeing the case and monitoring the debtor's progress towards a plan. However, because this trustee lacks many of the powers of a creditors' committee, unsecured trade creditors may find the trustee less aggressive in protecting creditors' interests.
3. **No U.S. Trustee fees:**
   The elimination of U.S. Trustee fees reduces the debtor's financial burden, potentially allowing more resources to be allocated toward paying creditors. While this may marginally increase the funds available for distribution, it also means that creditors cannot use the financial pressure of these fees as leverage during negotiations.
4. **True exclusivity:**
   This true exclusivity limits the ability of non-debtors (e.g., creditors) to propose alternative plans that might be more favorable to creditors. It also reduces the negotiating power of creditors, as they cannot threaten to file their own plan if they disagree with the debtor's proposal.
5. **Expedited timeline:**
   For credit professionals, this means less time to assess the debtor's financial situation, review the plan and prepare objections or negotiations. The expedited timeline can pressure creditors to make quick decisions, sometimes without sufficient information.
6. **No disclosure statement required:**
   Trade creditors may have less detailed information about the debtor's financial situation and the proposed reorganization plan, making it more challenging to evaluate the plan's impact on their claims. This can result in a higher risk of agreeing to terms that are not in their best interest.

7. **Less strict confirmation requirements (e.g., no requirement for an impaired consenting class):** This lowers the bar for plan approval and reduces creditors' ability to block plans they find unfavorable. Trade creditors may face a higher likelihood of being bound by a plan that doesn't fully protect their interests, especially if they are unsecured creditors.

8. **Risk of stretching out administrative expense priority claims**: The provision allowing administrative expenses and certain priority claims to be paid in installments over the term of the plan can delay trade creditors' recoveries on *post-petition* claims. Instead of receiving immediate payment on the effective date or in accordance with ordinary terms, creditors may have to wait three to five years, increasing the risk of non-payment and reducing cash flow. This deferred payment structure can be particularly challenging for businesses relying on timely payments to maintain their operations. Trade creditors have complained that Subchapter V debtors have failed to make all payments due under their confirmed plans, increasing the rate of failure.

9. **No absolute priority rule protecting general unsecured creditors:** Unsecured trade creditors may find they have less leverage in negotiations, as the absence of the absolute priority rule means that their claims do not necessarily need to be fully satisfied before the owners of Subchapter V debtors can retain their equity interests.

10. **Cramdown provision (e.g., projected disposable income):** The Subchapter V debtor's owner can retain the equity in the company without providing any contribution to the plan, so long as the Subchapter V debtor pays its projected disposable income over the life of the plan. Not only does this increase the risk of lower recoveries on account of trade creditors' unsecured claims, but it also raises a compelling question, what happens if the debtor's actual income over the life of the plan ultimately exceeds the amount projected at the time of confirmation; can the debtor be compelled to include a "true-up" provision in the plan that calls for the upward adjustment of plan payments accordingly? As discussed in the "case law" section below, different courts may have conflicting answers to this question.

11. **Nondischargeability:** The ability to block the discharge of debts owed by non-individual Subchapter V debtors tied to various instances of debtor misconduct provides an essential safeguard for unsecured trade creditors, ensuring that they are not left without recourse if a debtor has engaged in wrongful conduct (see discussion in the "case law" section below).

RISK MITIGATION STRATEGIES

Credit professionals may be sitting on a ticking time bomb without even knowing it. In fact, as of 2023, 40% creditors did not know what percentage of their portfolio was made up of customers who qualify for Subchapter V bankruptcy, according to an *eNews* poll—and the 31% who do know the answer say 10% or more of their portfolio qualifies for Subchapter V.

Creditors must be aware of how many of their customers could file using this subchapter because it makes it much more difficult to collect debt. Trade creditors might even consider placing eligible customers in a higher risk category because there will be a lot more factors working against the creditor if the customer files. There is an additional layer of risk with Subchapter V that does not exist in the traditional Chapter 11 route, and debt recovery may not be as likely or timely.

From a creditor's perspective, the key is anticipating and mitigating risk immediately, especially when you know a customer is insolvent. Creditors should make sure to get alerts to customer red flags, such as a customer building up inventory after years of not buying much product.

Revisit your credit policy and credit agreements and try to secure collateral where possible using letters of credit, security deposits and secured interest. "Monitor your accounts receivable (AR) closely," said Mike Mandell, corporate collection manager at Ryder Truck Rental, Inc. (Miami, FL). "For a Subchapter V, I recommend people talk to the trustee. I would try to see who some of the other unsecured creditors are to band together to look at how you can get better oversight in the case . . . There, you can lobby to get some of the rules changed on Subchapter V because it has not gone well for unsecured creditors."

Trade creditors should roll up their sleeves instead of sitting back and relying on a Subchapter V trustee to vet the debtor's projections since, ultimately, the debtor's unsecured creditors will be adversely impacted by projections that provide for relatively minimal distributions. If the debtor's projected disposable income isn't properly vetted during the debtor's plan confirmation process, trade creditors may be stuck with receiving distributions on account of their claims that are far less than what the debtor may ultimately be able to provide—essentially putting the cost of the debtor's reorganization on creditors. As discussed below, case law is split as to whether a Subchapter V debtor can be compelled to include a "true up" provision in its plan that gives creditors the upside where the debtor's actual income exceeds the debtor's projections.

Nondischargeability is another risk mitigation strategy, referring to certain debts that cannot be eliminated through bankruptcy proceedings. For B2B credit professionals, this concept becomes especially relevant when dealing with customers who have provided false financial statements or other false information or engaged in fraudulent or abusive activities. Under Subchapter V, creditors may have the power to challenge the dischargeability of debts if they can prove that these debts were incurred through fraudulent means (as discussed further in the "case law" section below).

Credit professionals should conduct rigorous financial assessments of their customers before extending credit. By scrutinizing financial statements and verifying their accuracy, credit professionals can identify potential red flags early on. If a customer later files for Subchapter V and it's discovered that they provided false financial information, the creditor may challenge the dischargeability of the debt and retain the right to pursue full repayment.

> "MONITOR YOUR ACCOUNTS RECEIVABLE CLOSELY. FOR A SUBCHAPTER V, I RECOMMEND PEOPLE TALK TO THE TRUSTEE. I WOULD TRY TO SEE WHO SOME OF THE OTHER UNSECURED CREDITORS ARE TO BAND TOGETHER TO LOOK AT HOW YOU CAN GET BETTER OVERSIGHT IN THE CASE . . . THERE, YOU CAN LOBBY TO GET SOME OF THE RULES CHANGED ON SUBCHAPTER V BECAUSE IT HAS NOT GONE WELL FOR UNSECURED CREDITORS."
>
> —Mike Mandell

CASE STUDIES

> "I HAVE ONLY SEEN ONE CUSTOMER SO FAR SUCCESSFULLY COMPLETE THEIR SUBCHAPTER V PLAN. FEW OF THESE CASES HAVE LONG-TERM SUCCESS ON THE REORGANIZATION SIDE."
>
> —Mike Mandell

NACM ADVOCACY

In early November 2023, several B2B credit professionals, representatives of the esteemed National Association of Credit Management (NACM) and attorneys from Lowenstein Sandler specializing in bankruptcy and creditors' rights recently convened with the American Bankruptcy Institute's (ABI) Subchapter V Task Force to exchange invaluable insights gleaned from their cumulative experiences in Subchapter V cases. These credit professionals played a pivotal role in creating this open dialogue, shedding light on important matters related to Subchapter V.

NACM members testified that with a $7.5 million debt ceiling, Subchapter V bankruptcies expanded to include medium-sized businesses rather than only small businesses. Some quotes from the trade creditor participants are provided below:

- "The Subchapter V plans that Ryder has been involved in have failed as the customer stops paying," Mandell said. "I have only seen one customer so far successfully complete their Subchapter V plan. Few of these cases have long-term success on the reorganization side, this is largely to be expected though. If you look at the success rate of Chapter 13 cases, it is similar. They confirm a plan and are not able to perform most of the time."
- Credit professionals testified that debtors should not be able to use Subchapter V to prolong the life of a company that cannot successfully reorganize. A primary concern of trade creditors is the inherent imbalance created by Subchapter V. Subchapter V allows small businesses to avail themselves of substantially all of the benefits of a traditional Chapter 11 case through an expedited process at a minimal cost to the debtor. However, the creditors who bear the burden of those benefits are left without the most significant protections of Chapter 11 and, to protect their interests, would have to incur the same costs. "The lack of disclosures and the reduction of available information for creditors in this subchapter is a major pain point," said Conrad Ragan, director of corporate credit risk at PepsiCo (Winston Salem, NC).
- "We do business with companies across all industries and sizes, so we have seen quite a few different types of bankruptcies, including many Subchapter V cases over the last few years," said Jeff Weber, director of credit at Uline (Pleasant Prairie, WI). "These claims can be made over three to five years, so it creates a burden for us to collect and ensure payments are being made."

- For Marlene Groh, CCE, ICCE, regional credit manager for US LBM Holdings, LLC (Buffalo Grove, IL), only two customers have filed under Subchapter V. Of the two, one was eventually converted to a Chapter 7 liquidation, while the other has been successfully working its way through the Subchapter V plan for reorganization. The success of the filing hinged on securing critical vendor status and having an experienced trustee at the helm of the reorganization. "By obtaining critical vendor status, we were able to recover about a third of the debt owed in the critical vendor approval process," Groh said.

> "THE LACK OF DISCLOSURES AND THE REDUCTION OF AVAILABLE INFORMATION FOR CREDITORS IN THIS SUBCHAPTER IS A MAJOR PAIN POINT."
>
> —Conrad Ragan

CASE LAW

Recent court decisions highlight differing interpretations of Subchapter V requirements that are of particular interest to trade creditors:

True-up provisions: In January 2023, the Middle District of Florida in *In re Staples* ruled that a Subchapter V debtor may be compelled to include a "true-up" provision in it's Subchapter V plan that requires distributions to creditors to be adjusted in the event the debtor's actual income exceeds the income the debtor projected at the time the plan was confirmed. However, in April 2024, the Western District of Texas in *In re Packet Construction, LLC* disagreed, holding the debtor cannot be compelled to include such a provision in its plan.

Applicability of individual exceptions to discharge with respect to non-individual Subchapter V debtors: Courts are split as to whether the exceptions to discharge under § 523(a) of the Bankruptcy Code—which traditionally only applies to individual (i.e., non-corporate) debtors—may be asserted against corporate Subchapter V debtors. The U.S. Courts of Appeals for the Fourth and Fifth Circuits (which collectively cover the federal district and bankruptcy courts in Maryland, Virginia, West Virginia, North Carolina, South Carolina, Louisiana, Mississippi and Texas) have held that they can be, thereby giving creditors a significant edge where an exception may be applicable—e.g., where the debt at issue was incurred via fraud. However, other jurisdictions may rule otherwise; for example, the Ninth Circuit's Bankruptcy Appellate Panel has held that the exceptions to discharge under § 523(a) apply only to individual debtors, even in Subchapter V.

> "BY OBTAINING CRITICAL VENDOR STATUS, WE WERE ABLE TO RECOVER ABOUT ONE THIRD OF THE DEBT OWED IN THE CRITICAL VENDOR APPROVAL PROCESS."
>
> —Marlene Groh, CCE, ICCE

RECOMMENDATIONS/ CREDIT PROFESSIONALS RESPOND

Ensuring proper notice and enhancing recovery mechanisms can improve the efficiency and fairness of the Subchapter V bankruptcy process, benefiting both creditors and debtors. Creditors may be hesitant to extend credit to customers that are at risk of filing, or have filed, Subchapter V bankruptcy due to the potential risks and uncertainties discussed above. Below are proposals aimed to create a more transparent and equitable bankruptcy process that may lead to better outcomes for all parties involved:

1. **Enhanced notice mechanisms:**
   Free access to ECF/PACER for Subchapter V cases, automatic ECF notices to creditors and comprehensive explanations about the roles of Subchapter V Trustees and U.S. Trustees/Bankruptcy Administrators.
2. **Improved disclosures:**
   Debtors must provide detailed financial disclosures under oath, including the financial difficulties that led to the filing, a strategy to rehabilitate the business, historical cash flow for the three years before the filing.
3. **Increased creditor involvement:**
   Requiring an impaired class or unsecured creditor class to vote in favor of the plan and appointing an official committee of unsecured creditors for cases exceeding certain debt thresholds.
4. **Administrative claims:**
   Restricting the ability of debtors to defer payment of administrative claims, ensuring they are paid in full on the plan's effective date.
5. **Role of Subchapter V Trustee:**
   Enhancing the diligence and oversight responsibilities of the Subchapter V Trustee, including vetting plan projections, the power to investigate and pursue causes of action against third parties or challenge prepetition liens and monitoring debtor compliance post-confirmation.
6. **Enforcement mechanisms post-confirmation:**
   General unsecured creditors and the Subchapter V trustee should have the right to request changes to the confirmed plan if the Debtor's actual disposable income turns out to be much higher than expected.
7. **Discharge for corporate Subchapter V debtors:**
   The current rules for discharging claims against corporate entities under Subchapter V should remain unchanged.

These changes could lead to a more balanced approach to resolving financial distress, ensuring that everyone’s interests are considered and that the process is more just and predictable.

- The $7,500,000 limit expired on June 21, 2024 and the debt limit under Subchapter V is currently reduced to $3,024,725. It’s always possible that Congress revisits the debt limit in the future given the popularity of Subchapter V among debtors and bankruptcy professionals.
- It is critical for creditors to remember that even though their claims or prospects of a meaningful recovery in Subchapter V cases may often seem minimal compared to many traditional Chapter 11 cases, the Subchapter V debtor may still achieve virtually all of the same objectives with all of the same advantages as in a traditional Chapter 11, with creditors being bound by the terms of any confirmed plan just the same. Therefore, if feasible, creditors should closely monitor Subchapter V cases in which they have claims or are otherwise involved and protect their interests where necessary.

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