WILMERHALE

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By email to

Senator Charles E. Grassley
Chairman, Senate Committee on the Judiciary
135 Hart Senat Office Building
Washington, D.C. 20510

Dear Senator Grassley:

I write in response to your March 14, 2018 letter regarding my March 7 testimony on the topic of small business bankruptcy before the Senate Committee on the Judiciary, Subcommittee on Oversight, Agency Action, Federal Rights, and Federal Courts. I very much appreciate the opportunity to share my perspective on these important issues. I am also grateful for the thoughtful follow up questions that Senators Sasse and Whitehouse have posed.

In responding to the specific questions, and to assist the Committee as it considers the various specific proposals for reforming the bankruptcy system to make it more accessible to small businesses in financial distress, I thought it would be helpful to set forth a few "first principles" that have historically served as touchstones of bankruptcy law and policy. In bankruptcy as in any other area of law, adherence to clear, just, simple, and easy-to-administer principles is most likely to bring clarity to the law and yield sensible outcomes.

Both businesses and individuals that face financial distress can access the bankruptcy system. But the fundamental bargain that bankruptcy offers individuals is dramatically different – for necessary and obvious reasons – from that offered to businesses.

What the two have in common is that there are times when the most appropriate course, for either an individual or a business entity, is simply to have a trustee liquidate their assets for distribution to creditors. That is what happens in chapter 7 – a chapter of the Code that applies to both individuals and businesses, including both large and small corporate entities.

U.S. bankruptcy law provides, however, alternatives to liquidation both for individuals and for business entities. For a corporation, the signal American contribution to insolvency law is the innovation reflected in chapter 11 of the Bankruptcy Code – the notion that the "going concern" value of the corporation often exceeds its liquidation value, such that creditors would be better served by allowing the business to continue as an operating business, with the value of the business (typically reflected in the shares of the reorganized debtor) distributed to pre-bankruptcy creditors, in order of priority, on account of their pre-bankruptcy debts. An important aspect of this scheme is the notion of absolute priority – that the pre-bankruptcy

owners cannot retain value on account of their pre-bankruptcy ownership interests unless the creditors are paid in full.

Those principles are embodied in chapter 11 of the Bankruptcy Code and have been repeatedly emphasized by the Supreme Court. Because these chapter 11 principles involve sometimes-elaborate procedural protections for creditors, the process can at times be lengthy, complex and expensive. Chapter 11 is built on the assumption that the debtor (through existing management) will in most cases remain "in possession" of its assets. Rather than relying on an impartial trustee to look out for the interests of creditors, an underlying assumption in the typical chapter 11 case is that the creditors will actively participate (either individually or through an official committee, whose professionals are paid out of the bankruptcy estate) in the process – ultimately negotiating and voting on a plan that is in most cases drafted and proposed by the debtor. These principles and procedures make good sense as applied to large and complex business entities. Most of the empirical evidence supports the proposition that the chapter 11 process has worked quite well at preserving, as going concerns, businesses whose value as an operating business exceeds their liquidation value. Indeed, the chapter 11 process played an important role in the U.S. economy's robust recovery from the financial crisis of 2008-2009.

Chapter 11's principles, however, are not and cannot be applied to individuals – human beings who will continue to live after the bankruptcy case and who do not have "equity interests" that can be distributed to pre-bankruptcy creditors on account of their prepetition claims. Instead, U.S. bankruptcy law offers individual debtors a very different bargain. In substance, it allows individual debtors to keep their pre-bankruptcy assets so long as they agree to commit their projected disposable income over a 5-year period of time to repay their creditors.

While it is true that many chapter 13 cases ultimately fail, chapter 13 has undoubtedly permitted a great many individuals and families who have struggled with financial distress keep their homes, cars and other assets, while at the same time taking appropriate steps (by committing their projected disposable income to their plans) to ensure that their creditors are treated fairly and equitably. In addition to reflecting some very different basic principles, chapter 13 also operates quite differently from chapter 11. It is much simpler and less expensive. It relies heavily on relatively brief and simple standard forms, rather than requiring lawyers to draft lengthy and complex documents. Creditors do not vote on a plan and generally are not expected to play an active role in monitoring the bankruptcy case. Instead, every jurisdiction has a standing chapter 13 trustee. These standing trustees generally do superb work in ensuring that debtors are making the required payments, taking appropriate remedial action when necessary, and distributing the funds they receive to creditors.

In the mid 1980s, in response to declines in farm incomes and a rash of farm foreclosures, Congress enacted Chapter 12 of the Bankruptcy Code. This chapter was generally modeled on Chapter 13. The central insight, even if not articulated in quite these terms, was that a family

farming or fishing business—which is defined in the Bankruptcy Code to include farming or fishing operations that are carried out by individuals and families regardless of whether the business is incorporated under state law and is thus a legal "person" separate from the individuals—is much more like a person than it is like a large corporate entity with a complex capital structure. Accordingly, it only makes sense for bankruptcy law to offer that family farmer the same fundamental bargain that chapter 13 offers to individuals. If the farmer is prepared to dedicate the farm's projected disposable income over the next five years to repaying the debts due to creditors, the farm can receive a discharge of its pre-bankruptcy debts and the opportunity to take advantage of a fresh start. Even if the family farm had technically been incorporated, it was, fall all intents and purposes, the alter ego of the individual or family who operated the farm. In this context, the fundamental principles of chapter 11, such as the absolute priority rule's requirement that the farm's creditors out of the equity of the post-bankruptcy farming business before the farmer can retain any interest in it, is simply inapposite. In order to limit this relief to the family farm, and not create an exception that will swallow the rules that have worked effectively for larger corporations, the Bankruptcy Code limits access to chapter 12 to farms whose debts are less than $4.15 million and excludes corporate entities whose shares are publicly traded.

While not every chapter 12 case succeeds, by most accounts chapter 12 has generally been successful in allowing many family farmers to weather economic distress. And much of the credit for this success goes to the dedicated work of the standing trustees who work with the farmers to ensure that they remain current on their plan obligations and take the necessary and appropriate steps to protect the interests of creditors when they are required to do so.

There is no reason as a matter of bankruptcy law or policy why the central insight that animated chapter 12 does not apply with equal force to the corner grocer, local hardware store, or family-run dry cleaning business. Much like the family farmers during the farm crisis of the 1980s, many of these small family businesses find themselves buffeted by larger economic forces affecting their communities. And chapter 11 as it is presently structured is simply too expensive and complex to provide a solution to their financial troubles.

Permitting such family-run businesses to obtain the benefit of a fresh start in bankruptcy so long as they are prepared to commit the business' projected disposable income over a five-year period to repaying creditors – without requiring strict adherence to the traditional requirements of chapter 11 such as the absolute priority rule – makes as much sense for these businesses as it does for the family farmer. Moreover, in addition to the use of simple forms and less elaborate procedures than apply in chapter 11, there is every reason to believe that these bankruptcy cases would benefit from the diligent work of standing trustees in the same way that many chapter 12 cases have.

For these reasons, I am generally supportive of the proposed subchapter V to chapter 11 proposed by the National Bankruptcy Conference (attached to my prepared testimony before the Subcommittee), of which I am a conferee, but whose proposal was adopted prior to my admission. There are some small areas where my own views of the best approach to this question depart slightly from the NBC proposal. For example, while the NBC's proposal for seeking creditor consent is far simpler than the elaborate disclosure statement/solicitation/voting approach that otherwise applies in chapter 11, I think the even simpler approach reflected in chapters 12 and 13 – that a plan may be confirmed so long as it meets the substantive statutory requirements without requiring creditor approval (and the implicit suggestion that the debtor will engage in extensive negotiations with its various creditor over the plan's treatment of their claims) makes more sense in the small business context. Similarly, I believe the approach reflected in those chapters – that the trustee remains in place and the discharge is not formally granted until the completion of the plan – operates to encourage debtors to meet their plan obligations and complete their plans successfully. I do not see a reason to depart from that approach here.

While I have not undertaken to craft specific legislative language to capture the points set out above, to the extent it would be helpful to the Committee, I would certainly be happy to do so.

With those comments as preface, I turn below to addressing the specific questions posed to me.

FROM SENATOR SHELDON WHITEHOUSE:

1. *Many small businesses are owned and operated by individuals. What benefits would be created by including individuals in new provisions to help small businesses reorganize?*

As described above, small family-run businesses (other than farming and fishing operations) fall into something of a donut-hole under existing bankruptcy law – too small for chapter 11, with its attendant processes, costs and delay to make sense, but as business entities not eligible for chapter 13. As such, they are effectively excluded from the benefits that bankruptcy law otherwise provides – the ability to continue business operations and seek a fresh start following financial distress, all while providing creditors treatment that is (and by law, must be) at least as good as they would receive in the event of liquidation. There is no reason why this ought to be the case. Granting these types of small businesses effective access to the bankruptcy system would operate both to preserve businesses and jobs, while creating valuable economic opportunities to the individuals and families who are able to save their family businesses thereby.

2. *Standing trustees have provided great benefit to family farmers and their creditors in chapter 12 cases. Would standing trustees be helpful in assisting the reorganization of small businesses? Should they be required in small business reorganizations?*

> Yes. As a general matter, standing trustees in cases under chapters 12 and 13 do terrific work. They look out for the interests of creditors (as is their charge), while at the same time working to ensure that debtors complete their plans and obtain the benefits of a fresh start. For all of the reasons they have been beneficial in chapter 12 and 13 cases, it makes very good sense to require the appointment of a standing trustee in a small business bankruptcy case. For that reason, and in order to avoid the expense and complexity associated with soliciting creditor votes, I respectfully disagree with the National Bankruptcy Conference's suggestion that a standing trustee not be appointed in cases in which creditors vote to accept the debtor's plan.

3. *Are there benefits to making small business bankruptcy voluntary and allowing small businesses to reorganize under chapter 11 if they so choose?*

> Sure. To the extent that a small business debtor believes that following the more elaborate procedures set forth in existing chapter 11 would be beneficial to it, there is no reason why such relief should not be available to it. But in light of the time, expense and complexity associated with a traditional chapter 11 case, I would expect it to be the very rare small business debtor that chooses that approach.

4. *Because small business reorganizations should move quickly, would it be appropriate to include a 90-day requirement to file a plan of reorganization, subject to extensions, just like the 90-day requirement that has worked so well in chapter 12?*

> Yes. I agree that this deadline (subject to extensions in appropriate cases) has operated to the benefit of debtors and creditors alike in chapter 12. I would retain it for small business bankruptcy cases.

5. *Because the cramdown provisions of chapter 12 that allow the debtor to retain property without paying creditors in full have worked well and are supported by practical experience and case law, shouldn't these provisions be part of any proposal to help small businesses reorganize?*

> My answer to this question is yes, but with certain caveats and limitations. Chapter 12, like chapter 13, permits a debtor to retain their pre-bankruptcy assets in exchange for paying its projected disposable income over the plan period to satisfy the claims of prepetition creditors. That approach – which in the case of the individual debtor simply reflects the basic differences between a person and a corporate entity – makes good sense

in the chapter 12 context, which is limited to family farms. It reflects the commonsense insight that even if a family farm is formally incorporated as a separate legal entity, it is at bottom the alter ego of the family that operates it. And creditors are in all cases entitled to receive no less than the value they would receive in a liquidation.

Applying this principle to other small family businesses outside of the farming context makes good sense, for the same reason that it appropriately applied to family farms. Extending it further than that –to larger or more complex businesses, could have serious consequences for lending markets. When lending to a true family business, lenders appreciate that as a practical matter the family operators are necessary for the business to generate revenues on a going concern basis. For larger or more complex businesses, however, lenders may reasonably extend credit with the expectation that, in the event the current operators become insolvent, the business might generate revenues that might be used to repay their debt in the hands of a third-party buyer. The traditional protections of chapter 11 are better suited for such a circumstance than the approach reflected in chapters 12 or 13.

One further point warrants comment. With the exception of first mortgages on principal residences, debtors in chapters 12 and 13 may "cram down" a secured creditor by paying that creditor the value of its collateral as of the effective date of the plan, which may be less than the outstanding balance on the loan. In the chapter 11 context, secured creditors are entitled to an additional protection reflected in section 1111(b) of the Bankruptcy Code, which permits the creditor to treat the claim as "fully secured." Debtors must pay that claim in full – though they may do so over time, with the present value of that stream of payments being equal to the value of the collateral as of the effective date.

This protection for secured creditors in large and complex cases is a valuable one. The procedures involved in making an 1111(b) election, however, are complex, as is the process of designing a plan (with an appropriate implied interest rate) that meets its requirements. I therefore believe that Congress made a sensible policy judgment in excluding the 1111(b) election from chapter 12. Extending that principle to other small family businesses makes sense for the same reason. But here, too, it is important that the more limited set of creditor protections remain confined to cases that are, in effect, more like individual debtor cases than they are like complex corporate cases.

FROM SENATOR BEN SASSE:

1. *What would be the impact of the ABI's equity retention proposal on small business lending practices?*

While I have the utmost respect for the members of the ABI Commission, I believe that their equity retention proposal risks serious harm to the lending markets on which many small businesses, including many that are never required to avail themselves of bankruptcy, depend. Unlike chapter 12 (which is limited to businesses whose indebtedness is less than approximately $4.15 million) or the NBC proposal (which is limited to businesses whose indebtedness is less than $7.5 million), the ABI Commission approach would potentially be applicable to businesses with up to $50 million in *asset* value, *without any limit at all* on the amount of indebtedness. Indeed, the ABI explains in its report that its approach would apply to more than 90 percent of all business bankruptcy cases. In my view, it would be a mistake to jettison the principle of absolute priority in the overwhelming majority of business bankruptcy cases. Lenders today have the benefit of knowing that a borrower is required to repay their debt in bankruptcy before the owner of the business is permitted to retain value on account of their ownership interest. That principle is a pillar of the lending markets. While I believe the small change suggested by the NBC of extending the principles of chapter 12 from the family farm to other small family businesses makes sense, there is every reason to worry that more broadly jettisoning the time-tested principle of absolute priority could have serious negative consequences on both the price and availability of credit for small businesses that depend on it.

2. *Are you concerned about the willingness of unsecured creditors to hold preferred equity in a small business?*

Yes. From the perspective of small businesses, the problem with existing bankruptcy law is that it is too complicated. While there are businesses that for good and sound reason adopt complex capital structures including ones with different levels of equity holding different priorities and liquidation preferences, it is hard to see why a local family-run diner or hardware store would choose to adopt such a structure. Moreover, an outsider that holds equity in a small and closely-held business is in a precarious position, needing to monitor (if it wants to protect the value of its equity stake) the operations of a business that (by definition) is not a public company and thus not subject to the various reporting requirements designed to protect the investing public. The proposed preferred equity contemplated by the ABI Commission goes in the wrong direction – it adds complexity rather than simplicity. The Commission was perhaps justified in believing that some protection in this direction was necessary if one wanted to address not only the family business, but also certain larger business enterprises. In my view, however, it would be

more appropriate to tackle the problems faced by family businesses by making the tools that we know have worked for family farms under chapter 12 available to them. With the benefit of that experience, it may then be appropriate to assess whether other changes should be made to chapter 11 to address the issues faced by larger and more complex businesses, that cannot already be addressed by the flexibility that chapter 11 already affords.

3. *The Bankruptcy Code already includes provisions for oversight from the U.S. Trustee, the ability to appoint an examiner, and the ability to retain professionals. In light of these, what is the need for a standing trustee or estate neutral?*

As described above, I believe that standing trustees have generally done excellent work in ensuring that individual debtors in chapter 13, and family farms in chapter 12, meet their obligations under their plans and in protecting the interests of creditors. I believe they would also prove successful in bankruptcy cases of small family businesses outside the farming context.

4. *How would a chapter 13 approach to issues with the absolute priority rule differ from the ABI's SME Equity Retention Plan?*

The most important difference is that the chapter 13 approach would presumably be applied only in cases in which it makes sense to say that the treatment bankruptcy law has long considered appropriate for individuals – replacing absolute priority with a requirement that a debtor pays its projected disposable income over a period of years to satisfy prepetition debt – is appropriate: cases of small family businesses in which the business operations are effectively the alter ego of the individual or family. The ABI's SME Equity retention plan would apply across a much larger swath of chapter 11, potentially to any case with assets of $50 million or less and without any limitation on the amount of indebtedness. In addition, the ABI's approach of giving prepetition creditors a form of preferred stock with (purported) economic value but without voting rights adds enormous complexity. The chapter 13 approach is far simpler, and therefore (especially in this context) preferable.

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I hope the Committee finds this additional material helpful as it undertakes the important task of seeking to make the bankruptcy process more accessible to small businesses who could benefit from bankruptcy's useful and powerful tools. If there is any other way in which I can be

of assistance as the Committee undertakes this important work, please do not hesitate to reach out.

Respectfully submitted,

Craig Goldblatt