Prepared Testimony of Edward J. Janger

Hearing of the Senate Judiciary Subcommittee on Oversight, Agency Action, Federal Rights, and Federal Courts on Small Business Bankruptcies

Tuesday March 7, 2018 at 2:30

Thank you for inviting me to share my thoughts on small business bankruptcies and, in particular the American Bankruptcy Institute Commission Report on Chapter 11, and various recommendations of the National Bankruptcy Conference relating to small businesses and financial institutions. I understand that there is particular interest in three topics, but I would be happy to take questions on others. Those topics are (1) proposals for reform of Chapter 11 in regard to small businesses; (2) proposals to make bankruptcy work better for financial institutions; and (3) student loans.

Student Loans. I will address student loans first, as they are not addressed in the ABI Commission Report, nor has the NBC made a recommendation. Also, they are not an issue that is governed by Chapter 11. They are, nonetheless a bankruptcy matter of crucial importance both for our financial system and society. They are perhaps the most broad-based program through which we, as a country, invest in human capital. Under current bankruptcy law, student loans are virtually non-dischargeable.[1] Like a number of provisions in the Bankruptcy Code, the student loan non-dischargeability provisions are based on the odd proposition that hard bargains are good for poor people; it is assumed that by enhancing the remedies available to student loan lenders, the cost of those loans will be lower.

In the case of student loans, this approach is misguided. Student loans encourage young Americans to take a gamble on upward mobility -- to take out a loan so that they can join the middle class. Because of student loan non-dischargeability, where that gamble fails, we treat this decision more harshly than other credit decisions – such as to use a credit card to buy a video game console. To make matters worse, the effect is regressive. It hits the poorer student borrowers harder than those with more resources. As Abbye Atkinson found, in a 2010 study of African Americans in bankruptcy, the borrowers who need the loans the most are also the ones who are hit hardest.[2] For these reasons, there are good reasons to consider revising the

---

[1] The standard is articulated in *Brunner v. New York State Higher Education Services Corp.,* 831 F.2d 395 (2nd Cir 1987). In that case the court explained that "undue hardship" requires a three-part showing: (1) that the debtor cannot maintain a "minimal" standard of living if forced to repay the loans; (2) that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay. *Id.*

[2] Abbye Atkinson, *Race, Educational Loans & Bankruptcy*, 16 MICH. J. RACE & L. 1 (2010). (Available at: http://repository.law.umich.edu/mjrl/vol16/iss1/1).

current bankruptcy rules regarding discharge of student debt to specify with greater clarity the situations under which they might be discharged.

Small Business Bankruptcy

In 2006, I had the privilege of serving as a consultant to the Business Bankruptcy Subcommittee of the Federal Bankruptcy Rules Advisory Committee. In that capacity I was responsible for compiling official forms for Small Business Plans of Reorganization and Disclosure Statement. The hope was that such a plan would allow small businesses to make more effective use of Chapter 11.[3] One thing I learned as part of that exercise was that it was impossible to draft a streamlined form that complied with the requirements of Chapter 11 *and* was suitable for the needs of a small or medium sized business. The need for a creditors' committee, and the rules for disclosure, solicitation and voting alone were likely to demand too much of many small businesses trying to stay afloat. What was needed was a set of special rules for small cases that would make Chapter 11 cost effective. These rules would need three attributes:

1. Clear rules about applicability, to prevent fights at the beginning of a case as to which rules applied.
2. Because effective creditors' committees are rare in small business cases, there needs to be an alternative means to supervise the debtor-in-possession.
3. As in Chapter 13, there needs to be an "off the shelf" formula for a plan that can be confirmed without going through the costly process of obtaining class acceptances.

Both the National Bankruptcy Commission and the American Bankruptcy Institute have offered thoughtful proposals to address each of these concerns about small business bankruptcies.[4] The differences between the two proposals are instructive. Both include useful features, and offer a way forward. The differences reflect important legislative choices.

First, the NBC proposal would define eligibility for small business treatment based on the amount of noncontingent liquidated debt – not to exceed $7,500,000. The Commission Report, by contrast, has a slightly more complicated threshold for eligibility: (1) neither assets nor liabilities can exceed $10,000,000; (2) the debtor must be a non-public company; and (3) larger debtors could opt into small business treatment, and the court would have to find that small business treatment is in the best interest of the estate. On the one hand, the Commission recommendation captures a number of key features that are not included in the NBC proposal: weighing assets and liabilities captures another way that a firm can be "large," as does status as

[3] The current version of those forms are available here: http://www.uscourts.gov/sites/default/files/b_425a_1217_0.pdf, and http://www.uscourts.gov/forms/small-business-forms/disclosure-statement-small-business-under-chapter-11

[4] The National Bankruptcy Commission Proposal formed the basis for S.3675 introduced on July 19, 2010. The ABI Commission recommendations can be found here: http://commission.abi.org/full-report. The recommendations relating to small businesses can be found, beginning at page 274.

a public company. Whether there are meaningful numbers of insolvent firms with assets that exceed their liabilities, or that are public companies is an empirical question. One aspect of the ABI Commission proposal that is concerning is the omission of a requirement that liabilities be "noncontingent and liquidated." In such a case, a large *ad damnum* in a tort case might exclude the debtor from access to SME treatment, regardless of the merits of the claim.[5]

Second, with regard to supervision, both proposals recognize that it is unrealistic to expect an active creditors' committee to supervise the debtor in a small case, or to impose such costs on the estate. The NBC report proposes the use of a standing trustee to supervise all cases, as is done in Chapter 13, while the ABI Commission Report recommends the court be empowered to appoint an estate "neutral," along the lines of the "examiners" that are sometimes appointed in Chapter 11 cases. Each of these approaches has strengths and weaknesses. A standing trustee is likely to be considerably less expensive than a traditional Chapter 11 trustee. However, the concept of an estate neutral provides a degree of flexibility as to the role of the neutral. While a standing trustee can ensure that the required payments are made under the plan, the standing trustee might not have control of the debtor in the way a Chapter 11 trustee might. The estate neutral contemplated by the ABI Commission would not be appointed in every case, but where necessary could be tailored to the needs of the case.

Third, and finally, both the NBC and the Commission Report allow for traditional acceptance of a plan by all impaired classes, but both also propose a mechanism for confirming a plan without the cumbersome need to procure class acceptance.

- Under the NBC proposal, the proposed plan would have to provide for payment in full of a secured creditor's allowed secured claims, and that the debtor commit substantially all of its disposable income for 3-5 years to payments under the plan.
- The ABI Commission Report envisions a more complicated approach to cram down. Secured creditors would need to be paid the value of their collateral. Unsecured creditors would be given preferred stock entitling them to 85% of any dividends or distributions. Old equity would retain 100% of the common stock, on the condition that they continue to assist in the management of the debtor. After 4 years, the preferred stock would "mature" and would convert to 85% of the equity of the country, unless the unsecured creditors were paid in full.

Again, while the ABI Commission's proposal is much more complicated, the general import of the proposals is the same. The secured creditors have a baseline entitlement to the value of their collateral. The unsecured creditors have a baseline entitlement to the disposable income of the firm for 3-5 years. In both cases, old equity remains the residual owner, in return for their continued management of the business. Also, in both cases the option to deviate from

[5] The Commission Report does suggest that the court should have the discretion to grant SME treatment in such cases, but this may lead to costly wrangling at the beginning of a case that would eliminate much of the benefit of SME treatment.

this approach through a consensual plan is preserved. This basic approach is in line with the philosophy of Chapter 13, where a debtor is allowed to pay its creditors out of three to five years of disposable income.

One feature of both proposals bears mentioning. Both proposals require the payment of a secured creditor's allowed secured claim in full. This is appropriate, but it turns on a proper interpretation of the relationship between state law liens and Chapter 11. It relates to the way in which state law and Chapter 11 allocate value between secured creditors and the estate The assumption here is that the secured creditor's lien does not encumber all of the going concern value of the business. As Melissa Jacoby and I have explained elsewhere, this point is implicit in both the limits on state law liens under Article 9, and the treatment of those liens under the current Bankruptcy Code.[6] To put it bluntly, under either proposal, if the secured party could lien the going concern premium of the business, the amount necessary to pay the secured creditor may render the vast majority of plans unfeasible.

In short, both the NBC proposal and the ABI Commission's recommendations provide plausible approaches to reform Chapter 11 to deal more effectively with small businesses. The NBC approach is more streamlined. The Commission Recommendations more tailored.

Financial Institution Bankruptcy

Financial institution bankruptcy is a complex topic that requires more detailed treatment than can be provided in these short remarks. The NBC has taken a position on resolution of systemically important financial institutions (SIFIs) in bankruptcy, and the ABI has made recommendations with regard to treatment of qualified financial contracts (QFCs) under the Bankruptcy Code's safe harbors.[7] I have previously joined a number of other law professors in a letter to this Committee that echoes the NBC position -- that bankruptcy courts are not a congenial first instance forum for resolving SIFIs. A copy of that letter is attached. I have also co-written an article that relates to both the NBC and ABI recommendations.[8] I will broadly summarize my views below, and look forward to any questions.

---

[6] In a recent article Melissa Jacoby and I seek to show that a secured creditor's allowed secured claim is limited to the value of the debtor traceable to realization on assets owned on the petition date and their identifiable proceeds. Melissa B. Jacoby and Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11,* 96 TEX. L. REV. 673 (2018)(available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3048336#). The fact that both proposals seem to assume that this is the case is a feature of both, not a bug.

[7] The NBC's letter is available here: http://nbconf.org/wp-content/uploads/2015/07/2015-Jun-18-NBC_Ltr_to_Cong_re_SIFI_Bills.pdf. The ABI Commission's recommendations regarding QFCs begin at page 94 of the Commission Report.

[8] Edward J. Janger and John A.E. Pottow, *Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution,* 10 BROOK. J. CORP. FIN. & COM. L. 155 (2015)(available here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2841956.)

It is true, beyond peradventure that Chapter 11 as currently constituted does not work well for financial institutions. This is due, in large measure to the current exemptions of certain qualified financial contracts (QFCs) from the automatic stay and avoidance provisions under the so called "safe harbors." An example of the costs of the safe harbors can be seen in the Lehman bankruptcy, where the inability to accomplish an orderly transfer of Lehman's derivatives book led to considerable destruction of value, harming both Lehman's creditors and the financial system as a whole. Since Lehman, the financial world has moved forward. Key Attribute 4 of the FSB's Key Attributes for Effective Resolution Regimes, and the World Bank's Standard C10.4, each provide that, for financial institutions, a short stay of termination rights to allow for the orderly transfer of these instruments to a solvent counterparty.[9] The Bankruptcy Code doea not provide for such a short stay. As such, the Bankruptcy Code is not in compliance with current international best practices.

Proposals to remedy these problems for systemically important financial institutions (SIFIs), including proposed Chapter 14 are potentially helpful, but subject to two crucial qualifications: (1) with regard to SIFIs, improving the functioning of the Bankruptcy Code is *only* helpful if it is a compliment to the administrative regime provided by the Orderly Liquidation Authority created by Dodd-Frank; (2) limiting the proposed reforms to SIFIs misses the fact that not all financial institutions are SIFIs. Indeed, it is crucial that bankruptcy work better for financial institutions that are not SIFIs, and therefore not subject to Dodd-Frank and the OLA.

For the reasons stated in the attached letter and by the NBC, where SIFIs are involved, Dodd-Frank provides an essential layer of administrative supervision, and a backstop administrative procedure for resolving SIFIs in a manner calculated to minimize harm to the global financial system. It seems unlikely that if a global SIFI were to fail, bankruptcy court would be a dangerous place to experiment. But not all financial institutions are SIFIs. Proposed Chapter 14 has a threshold of $500,000,000,000 dollars in liabilities. This cutoff is, by necessity, somewhat arbitrary. Some institutions may move in and out of the category of SIFI. Some already have. Also, certain types of systemic risk may reside in financial institutions that are well below the threshold in size, simply because of the nature of their business. Some thought needs to be given to making bankruptcy courts a better resolution forum for the financial institutions that are actually below the SIFI threshold.

This concludes my remarks, and I thank you all for the opportunity to address the subcommittee. I hope that you have found my comments helpful.

---

[9] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, Attribute 4 (2011) (available at: http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/#4set-off); The World Bank, Principles For Effective Insolvency And Creditor/Debtor Regimes C10.4 (available at: http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf).

[ATTACHMENT]