BERN
STEIN
SHUR

Bernstein, Shur,
Sawyer & Nelson, P.A.
100 Middle Street
PO Box 9729
Portland, ME 04104-5029

T (207) 774-1200
F (207) 774-1127

Robert J. Keach
[redacted]

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Senator Charles E. Grassley, Chairman
United States Senate, Committee on the Judiciary

Senator Ben Sasse, Chairman
Subcommittee on Oversight, Agency Action, Federal Rights and Federal Courts

Re: Hearing: Small Business Bankruptcy: Assessing the System

Dear Chairman Grassley and Chairman Sasse:

Thank you once again for the opportunity to testify at the hearing entitled "Small Business Bankruptcy: Assessing the System" before the Subcommittee on Oversight, Agency Action, Federal Rights and Federal Courts. On behalf of the ABI's Commission to Study the Reform of Chapter 11 (the "Commission"), I also appreciate the opportunity to address the additional written questions submitted by Chairman Sasse. I do so below in the order in which they were presented.[1]

- **How have the 2005 changes to the Bankruptcy Code affected the environment for small businesses?**

  As detailed below, the 2005 changes focused only on the smallest businesses and created additional procedural and reporting burdens on those businesses. The effect of these changes, perhaps unintended, was to contribute to the failure of such businesses, making the small business provisions a conveyor belt to liquidation rather than a means of restructuring.

  The utility of chapter 11 for smaller companies is not a new concern. Shortly after the enactment of the Bankruptcy Code, practitioners, courts and commentators raised concerns regarding the ability of

[1] The answers are derived from Section VII of the Commission's Final Report and Recommendations found at commission.abi.org/full-report (the "Report"). For convenience and readability, the answers omit most of the footnotes contained in the extensively-sourced Report. Out of respect for those sources, and to readers of these answers who wish to access those sources, those sources can be found in the Report and are incorporated by reference.

smaller debtors to confirm chapter 11 plans. Congress attempted to address these concerns in 1994 by introducing a small business election provision in chapter 11. The 1994 amendments defined "small business" as "a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed $2,000,000." A person qualifying as a small business could elect into a fast- track chapter 11 plan process that allowed the court, among other things, to conditionally approve the debtor's disclosure statement and to combine the hearing on the adequacy of the disclosure statement and the approval of the plan. The amendments also allowed the court to order that a committee of unsecured creditors not be appointed in a small business case.

Congress further amended the small business provisions of chapter 11 in 2005 in response, at least in part, to the ongoing issues with small business cases identified by the National Bankruptcy Review Commission's (the "NBRC") study and report (the "NBRC report"). The NBRC report concluded that small business debtors fell into two categories: (i) a small number with a reasonable likelihood of reorganizing and succeeding as a going concern; and (ii) a larger number with no reasonable prospect of rehabilitation. The NBRC suggested that reform focus on increasing the likelihood of success for those debtors who might succeed and reducing the amount of time a likely-to-fail debtor spends in chapter 11. (A significant segment of insolvency professionals disagreed with the NBRC majority on these points).

The NBRC report concentrated to some extent on those small business debtors that were unlikely to rehabilitate. The NBRC report indicated that small businesses benefited from the protections of chapter 11 — the automatic stay, retention of control of the business, ability to delay payments to creditors, and ability to delay formulating a chapter 11 plan — while administrative costs increased, even though there was no realistic prospect of rehabilitation. According to the NBRC Report, chapter 11 arguably only prolonged these debtors' imminent demise and reduced recoveries for creditors. (Again, a significant segment of insolvency professionals disagreed with the NBRC majority on these points). The NBRC proposed reforms to address these likely-to-fail debtors and to try to reduce overall cost and delay for small business debtors. These changes included establishing presumptive and tight plan filing and plan confirmation deadlines, additional postpetition documentation requirements, more reporting, and changes to the burden of proof for small business debtors. In adopting these provisions, Congress also removed the elective nature of the small business provisions and amended the definition of the "small business debtor" that would be subject to these mandatory provisions.

At that time, a number of experts testified before the NBRC that the reduced deadlines would provide too little time and shifting the burden of proof would be too onerous, and that these provisions would deprive debtors of a fair opportunity to reorganize in chapter 11. Unfortunately, time has proven those experts right. Witnesses before the Commission generally testified that chapter 11 is not working for small and middle-market debtors, and several of these witnesses suggested that certain of the deadlines imposed by the BAPCPA amendments were particularly challenging and counterproductive for small business debtors.[2]

As noted above, Congress originally introduced the small business provisions into the Bankruptcy Code as an elective process. Debtors who satisfied the original definition of "small business" could elect to proceed with the fast-track plan confirmation procedures. Congress removed the elective nature of the small business provisions in 2005 pursuant to the BAPCPA Amendments. The current provisions mandate small business treatment if, among other things, the debtor has less than $2,190,000 in total secured and unsecured debts and there is no active unsecured creditors' committee in the case.

Although the current small business provisions are mandatory and self-executing, several commentators have suggested that small business debtors are not self-reporting and may not be proceeding as small business cases to avoid the pitfalls noted above. For example, Professor Robert Lawless observed that "there were 2,299 chapter 11s filed in 2007 where (i) the debtor was not an individual, (ii) [the debtor] said they had predominately business debts, and (iii) the total liabilities were between $50,000 and $1,000,000. Because very few small chapter 11 cases have unsecured creditors' committees, almost every one of these 2,299 cases should have identified as a small business debtor, but only 36.8 percent did so." The failure to self-identify as a small business debtor may be an oversight, it may be the result of the somewhat complicated definition of "small business debtor" described above, or it may be a desire to avoid the obligations and deadlines imposed on small business debtors under current law.

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[2] *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) (stating it is nearly impossible to do anything but have a section 363 sale in the middle market), *available at* Commission website. "Middle-market companies just do not have either the management or financial resources to attempt to remain in Chapter 11 long enough to reorganize." *Id. See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website; *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (requesting that the BAPCPA plan deadlines be repealed because "the secured lender is concerned about these deadlines and consequently takes action (or requires the debtors to take action) months before these deadlines occur in order to reduce its credit risk — all of which hurts the flow of funds to the debtor and ultimately inures to the detriment of the reorganization process"), available at Commission website.

Regardless of the reason, however, the consequences can be significant, including a subsequent determination that the small business debtor deadlines apply from the petition date, even if the non-designation is not corrected or is not deemed incorrect by the court until much later in the case. The case would then automatically fail.

- **Can you break down in further detail exactly how Chapter 11 can become so expensive for small business debtors?**

For the smallest businesses, as noted in the previous answer, the 2005 changes established tight, immovable plan filing and confirmation deadlines, additional postpetition documentation requirements, and more reporting requirements. Thus, these debtors often file nonconfirmable plans just to meet the deadlines, necessitating amendments, at additional cost. The additional disclosure and reporting also increases costs.

For larger SME's, they have the same reporting, disclosure statement and confirmation requirements as do the mega businesses, even though a more streamlined process would be adequate. This drives up professional fees. In such cases, when a creditors' committee can be formed, the U.S. Trustee must do so, and that committee gets its own set of lawyers and financial advisors, again driving up costs. The Commission's SME proposal encompasses streamlined reporting and plan confirmation procedures, and eliminates mandatory appointment of creditors' committees.

- **What is the downside of having mandatory oversight of a small business debtor in the form of an appointed trustee, similar to chapter 13?**

The Commission viewed the administrative and oversight functions in an SME case as critical to the utility and effectiveness of the SME principles. The Commissioners wanted to develop principles that encouraged SMEs to file chapter 11 cases when appropriate, which meant reducing costs, simplifying disclosures and the process, and providing a way for the prepetition managers to stay in control of the business with some financial guidance and counseling when needed. History has shown that when a reorganization filing option includes mandatory appointment of a trustee with management oversight authority, businesses will avoid filing under that option (such was the case with filing options prior to the Bankruptcy Code). Many witnesses testified to the Commission that SME's were avoiding chapter 11 altogether. These factors were taken into consideration as the Commissioners considered various alternatives for structuring the SME principles, including a chapter 13-like process for SMEs.

The Commission considered carefully a standing trustee system similar to that used in the chapter 13 context. In chapter 13 cases, the U.S. Trustee appoints a standing trustee in each jurisdiction. The trustee represents the estate, and he or she oversees the administration of the case, including the confirmation of, and distributions under, the debtor's rehabilitation plan. The trustee does not represent the debtor, but he or she may consult with the debtor, including with respect to issues in the proposed rehabilitation plan. One of the options considered was raising the chapter 13 debt limits to permit small businesses to file under chapter 13 or incorporating a more chapter 13-like process into chapter 11 for small businesses.

Upon deliberation, the Commission rejected the notion of either a standing trustee for SMEs or a chapter 13-like process for SME cases. The Commissioners noted that small business cases are not simply big chapter 13 cases. They highlighted the structural differences in business cases, including the debtor's contractual relationships with vendors and suppliers and its obligations to customers. SMEs also have employees to consider and operational issues that may complicate their restructuring alternatives. The range of issues encountered by larger SME's might be beyond the expertise of a generalist standing trustee. Finally, given the unquestioned history under the Bankruptcy Act and the Code, the Commissioners highlighted the ***likely reluctance of SMEs to file bankruptcy cases if the administration of their cases and perhaps their businesses would automatically be turned over to a standing trustee.*** The current SME proposals were deemed superior to a standing trustee model because the current SME proposals would encourage filing for reorganization when needed rather than exacerbating the current problem of SME's avoiding a filing by adding an automatic trustee to the calculation. The current SME proposals by the Commission allow for use of a tailored estate neutral where appointment will bring value, but the estate neutral would not take over the business (and thus the possibility of appointment would <u>not</u> chill filings).

The Commissioners also considered whether the traditional unsecured creditors' committee structure was an effective oversight mechanism for SME cases. They reflected on the witness testimony concerning the costs associated with unsecured creditors' committees, particularly in smaller cases. They also noted the creditor apathy that might prevent the formation of a committee in the first instance in SME cases. Most Commissioners agreed that committees could be effective in SME cases if creditors were engaged and representative of the general unsecured creditor body, ***and if costs could be contained***. They also agreed, however, that satisfying all of these criteria in an SME case was likely the exception rather than the rule.

I hope these responses fairly and completely address the questions posed. I would be happy to address them in greater detail should the subcommittee so desire. Again, on behalf of the Commission, I extend our appreciation for the chance to bring these important issues and reform proposals before the subcommittee.

Sincerely yours,

Robert J. Keach
Co-chair, ABI Commission
To Study the Reform of Chapter 11