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COULD BANKRUPTCY REFORM HELP PRESERVE SMALL BUSINESS JOBS?

HEARING

BEFORE THE

SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT AND THE COURTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

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COULD BANKRUPTCY REFORM HELP PRESERVE SMALL BUSINESS JOBS?

WEDNESDAY, MARCH 17, 2010

U.S. SENATE,
SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT AND THE COURTS,
COMMITTEE ON THE JUDICIARY,
Washington, DC

The Subcommittee met, pursuant to notice, at 10:33 a.m., Room 226, Dirksen Senate Office Building, Hon. Sheldon Whitehouse presiding.

Present: Senator Sessions.

OPENING STATEMENT OF HON. SHELDON WHITEHOUSE, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator WHITEHOUSE. The hearing will come to order.

I'm delighted to have the distinguished Ranking Member not only of this subcommittee, but of the Senate Judiciary Committee, Senator Jeff Sessions of Alabama, with us. I will make an opening statement and then recognize the witnesses and allow the distinguished Ranking Member to say a few words. Then we'll get to the testimony.

I will warn each of you that we have a 5-minute clock on the initial testimony, and I will use the gavel. So for those of you who have prepared longer remarks, spend some time to think about what your core message is that you can distill into 5 minutes of oral testimony.

While some economists have declared that the recession is over, its painful aftermath in the form of a prolonged period of unemployment continues nationwide. The national unemployment rate stands at almost 10 percent, and the situation is even worse in some areas; Senator Sessions' home State of Alabama has an 11.1 percent unemployment rate, and my home State of Rhode Island ranks third nationwide, at 12.7 percent. Job retention and preservation should be, and is, the top of our legislative agenda.

Today we are going to explore changes to the Bankruptcy Code that could help small companies to reorganize, stay in business, and keep employees employed. The ideas we will discuss today are worthwhile to consider for two reasons: 1) small businesses account for over half of all jobs nationwide; and 2) unlike other job-preserving measures like tax cuts and government investment, bankruptcy reform can be accomplished with zero cost to the Federal budget.

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While small business bankruptcy reforms may prove a powerful tool in cutting job losses, the need for a new bankruptcy reorganization option has been clear for some time. Chapter 11 was designed for large, publicly traded companies and does not work well for smaller companies for a number of reasons.

First, Chapter 11 extinguishes equity so the debtor-owners exit the bankruptcy not owning their company anymore. A change in shareholders may not discourage big corporations from reorganizing, but for small businesses the corporate entity and its owner are not so easily disaggregated.

Second, small businesses often have a number of trade creditors and other unsecured creditors that do not participate in a Chapter 11 because their claims are too small. This failure to participate leaves the secured creditors steering the bankruptcy, often toward liquidation.

Finally, the Chapter 11 process is time-consuming and expensive and attorneys' fees and other administrative costs often eat up so much of the firm's value that there's not enough left for the firm to emerge from bankruptcy as a going entity.

The National Bankruptcy Conference has proposed addressing these three issues by opening up Chapter 12, a process currently available only to family farms and fishermen, to a wider group of small businesses. I expect that Judge Small will discuss this proposal in his testimony today. I have reviewed the NBC's report and believe that they make a strong case for the Chapter 12 approach.

I want to stress, however, that I look forward to hearing the thoughts of all the witnesses on positive steps to promote small business bankruptcy reform. It appears from the written testimony that each of our witnesses acknowledges that certain changes to bankruptcy law might help to preserve small business value and to save jobs.

As we discuss the NBC proposal, there are a number of variables about which I'm interested in getting the witnesses' feedback: is the proposed definition of small business entity appropriate; should the reforms be made permanent or enacted on a trial basis, as Chapter 12 for family farms initially was?

Through it all, one thing is clear: small businesses are the lifeblood of our economy, particularly in Rhode Island, but nationwide. They are hurting now in today's economic climate. We should be considering all options, including reforms to our Bankruptcy Code, to help small businesses keep their doors open and keep their employees on the payroll. I look forward to a lively discussion with a distinguished panel of witnesses.

Ed Mendenhall owned a fitness center in Warren, Rhode Island from 1996 to 2009. In his testimony, Mr. Mendenhall will describe his efforts to save his business. Mr. Mendenhall is a graduate of the University of Rhode Island and has an extensive background in personal training, martial arts, and fitness.

Chuck Bullock practices bankruptcy law in Detroit, Michigan, sort of the epicenter, perhaps, for economic distress in our country right now. He has represented small business debtors and secured and unsecured creditors. A graduate of the University of Michigan and the University of Memphis School of Law, Mr. Bullock teaches bankruptcy at Cooley Law School.

Tom Small served as U.S. Bankruptcy Judge for the Eastern District of North Carolina from 1982 to 2009. He also served as president of the National Conference of Bankruptcy Judges and as a board member of the American Bankruptcy Institute. He holds degrees from Duke University and Wake Forest University School of Law. Judge Small continues to be an active member of the National Bankruptcy Conference and serves as co-chair of its Small Business Working Group. Judge Small helped Senator Grassley to draft the original Chapter 12 back in the 1980's.

Joseph Mason is the Herman Moyes Louisiana Bankers Association chair of Banking at the Louisiana State University, and Senior Fellow at the Wharton School. Dr. Mason's academic research focuses primarily on investigating liquidity in thinly traded assets and illiquid market conditions. A graduate of Arizona State University, he has an MS and Ph.D. from the University of Illinois.

Thomas Bennett has been a U.S. Bankruptcy Judge for the Northern District of Alabama in Birmingham since 1995. For over 15 years he was a partner with the law firm of Bowles, Rice, McDavid, Graff & Love, PLLC, and served as the head of the firm's Bankruptcy, Creditors' Rights, and Commercial Litigation practice groups. Judge Bennett graduated from Gerard College in Philadelphia, Pennsylvania in 1966 and received his undergraduate and graduate degrees in Economics, as well as his law degree, in from West Virginia University.

I now turn to our Ranking Member for any remarks he would care to make. Then we will swear the witnesses and proceed with the testimony, beginning with Mr. Mendenhall.

STATEMENT OF HON. JEFF SESSIONS, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator SESSIONS. Thank you, Mr. Chairman.

Of course, bankruptcy is a Federal court. Our economy evolves and bankruptcy rules and procedures, I think, should be reviewed by Members of Congress periodically to make sure that we are operating on the most effective, efficient level possible. Dynamic economic activity is part of the American strength, and being able to borrow money at a reasonable rate of interest is part of our American strength.

Business people who fail and just can't make it are able to walk away, often usually without—sometimes, at least I'll say—personal liability and can start again. Many people who have been successful in business have a history of having failed businesses before that. So, we are in a dynamic economy.

I think maybe the Japanese experience should share with us that keeping zombie banks and zombie institutions alive that really ought to go away and start over again can be a mistake also. So, we'll discuss those issues and remember that the freedom to succeed is also the freedom to fail, and people who wish to become rich 1 day aren't always to be provided assistance when they have not been successful.

So I hope we'll learn something today about how we can preserve and create new jobs by helping small businesses reorganize in a convenient, effective way, but in doing so I hope we'll balance the rights of those who've invested in these small businesses, too.

Many investors and lenders are small businesses themselves and we must be sure that we're not robbing Peter to pay Paul. We must make sure that we are not using our bankruptcy laws to force one small business to subsidize another small business.

Bear in mind that reorganization is not solely about keeping a failing business alive, it's about preserving the value of an operating business so that lenders can be paid back, if they can be, and also to give that company a chance to succeed through bankruptcy protection. So we've got to be careful about all of these issues.

It's great to have Judge Bennett here. He's well-respected in our State and throughout the bankruptcy community in America. He's been on our bench since 1995. Judge, we appreciate you and the resource and insight you've provided to me and my staff over the years.

Of course, we have the current choice between Chapter 7 and Chapter 11. Chapter 7 is liquidation and Chapter 11 allows a bankruptcy court to help reorganize the company in a way that allows it to be successful, to hold off certain creditors, and create a situation in which more creditors get paid more money than if one or two had come in and liquidated the company or destroyed the company just to get their short-term gain. I think that's a good policy.

As to whether we can use the agricultural idea, I guess I'll say I'm open to it, but I have some concerns about it. There is no doubt in my mind that if you recreate procedures that significantly reduce a secured creditor's priority in bankruptcy and in liquidation circumstances, then that secured creditor in the future will be less likely to loan money, and if he or she does, to do so with perhaps higher interest rates to guard against the dangers of the erosion of what they thought they had when they started out with a secure loan. There's just no free lunch here, somebody is going to pay.

Sometimes I think we should ask ourselves, who would best pay, the small business who made the loan? Should that person subsidize the failing small business or should we just have the taxpayers do it? It's easier for us to maybe require the person who made the loan to be responsible because if we would have to raise taxes or increase the debt if we do it otherwise. But as a matter of economics, I'm not sure which one is more morally defensible as a policy.

So I am open to this. Mr. Chairman, thank you for your leadership. I have confidence that we can find some things that we can agree on to make the system better, and hopefully we'll agree on the big things.

Thank you very much.

Senator WHITEHOUSE. Thank you, Senator Sessions.

If I could ask the witnesses to stand and be sworn.

[Whereupon, the witness was duly sworn.]

Senator WHITEHOUSE. Thank you very much. Please be seated.

I would like to welcome Edward Mendenhall from my home State of Rhode Island, a small businessman who for many years ran a small business in Warren, Rhode Island.

Mr. Mendenhall, please proceed.

STATEMENT OF EDWARD D. MENDENHALL, JR., SMALL BUSINESS OWNER, WARREN, RHODE ISLAND

Mr. MENDENHALL. Chairman Whitehouse and Ranking Member Sessions, thank you for the opportunity to appear today before the Subcommittee and tell my story, and for looking into ways to help small businesses stay open.

My story begins at the end of 1995, when I decided to open a health club in Warren, Rhode Island. I grew up in the area and recognized the need for a health club, so I decided to open one myself. Shortly thereafter, I secured a reasonably priced location, moved into the building, and began to renovate it 24/7 with the help of family and friends.

In October 1996, we officially opened the doors. Though the location wasn't ideal and the business was very young, we grew into a successful business and we were actually profitable from day one. We put every dollar back into the business and continued to grow and improve over the years. In 2001, we were able to endure the opening of a larger, better funded competitor because our customer base had grown so loyal.

In 2005, things took an unexpected turn when our landlord refused to renew our lease. While moving to a new facility and a better location was definitely part of our long-term strategy, the news was devastating at that time. Our type of business requires a large, open floor plan on a main road, and there were very few suitable locations in the area. To make matters worse, we didn't have the cash necessary to build out a new location at the time, so we were on the verge of losing everything we had worked so hard for all those years.

So the first thing we did was to enlist the expertise of a health club design and marketing firm to make sure we did it right. They began with a marketing analysis and we began the search for potential locations. We found ourselves with no other option than to lease space. At that time, there were only two spaces available for lease.

In late summer/early fall of 2006, we finally negotiated a deal to move into a shopping plaza and applied for the financing. Our financing needed to be secured by my personal home and assets. Now that we had the financing in place, we were waiting on the actual lease documents to be completed.

We needed to begin the renovations right away in order to make the January opening date. In the health club industry, the first quarter sets up the rest of the year, as more people are inclined to join the club after their New Year's resolutions.

As negotiations on the lease for the plaza space dragged on, another space opened up and we signed a lease with them in April of 2007. In the fall of 2007, we had the new space completely gutted and began the closing process with our bank. We again had hopes of a January opening to seize on the New Year's resolutions crowd, and continued to do what we could to keep the project moving forward. However, it wasn't until January that we were finally ready to close on the loan.

Days before the closing date, the bank informed us that a UCC filing had to be cleared before proceeding with the closing. Unfortunately, because my business partner couldn't use any collateral, the

bank that financed the stock purchase filed the UCC against our shares. By the time we found a solution and notified the bank that we were going to clear the UCC filing, they informed us that our file had been taken out of closing and sent to storage in another State.

We then had to begin the closing process all over again and had to resubmit all documentation. We were informed by a bank employee that, for the course of our loan, everyone at the bank involved with our loan had either been fired or quit during the process. Within the bank there was a lot of confusion, miscommunication, and misplaced documents. This caused the whole process to be far longer and more painful than it should have been.

The delays ultimately caused our original landlord to evict us in the summer of 2008. The eviction process began in July 2008, when our landlord literally began taking over our space and renovating around our customers while we were still trying to operate. Immediately our sales dropped by $10,000 per month, which equated to about 25 percent of our sales.

Luckily, we found a small vacant building around the end of September that was to serve as a temporary location. It wasn't ideal, but it did save us. We operated there until we opened the new facility in April of 2009. We finally closed on the loan in October of 2008 and the club opened in April 2009, 2 years behind schedule.

Our average sales prior to the eviction were enough to cover the minimal expenses at the new location, including the new debt service. A year of normal operations and growth in a new facility would have put us back on track. By the time the new club was open, we were behind in bills and needed to free up cash-flow so we would have a chance to breathe and focus on growing. We were looking for help everywhere: the Economic Development Corporation, the SBA, our banks, new banks, private investors, everywhere.

We had applied for an ARC loan to pay our equipment leases. If approved, it would have freed up $7,000 a month in working capital for 5 months. We couldn't even get the banks to take the application, never mind consider it. They said they just didn't want to be bothered with the paperwork.

We also applied for a deferment with our bank. We were told by the SBA that our bank could approve a deferment for up to 1 year without SBA approval. It took 4 months and a lot of paperwork just to get an answer. We were eventually granted a 3-month interest-only deferment. Unfortunately, this would not be a significant help.

An ARC loan and a longer loan deferment, by themselves, would have been enough to save the business if granted soon enough. This would have given us the time we needed to grow and catch up on the past-due bills. When we closed our doors, we had accumulated approximately $140,000 in past-due bills. Half of that amount also would have saved the business while we caught up with the rest over time. I guess when you look at the big picture, a relatively small amount of help would have helped us avoid having to go bankrupt with over $1 million in debt. A little flexibility on timing could have saved our business.

Last year we met with a bankruptcy attorney, hoping that if we filed we could buy enough time to make it to the first quarter of the year and get our business back on track. Unfortunately, the attorney told us our business value was too small to warrant reorganization in Chapter 11; the only bankruptcy option for us was liquidation.

We have now lost the business, our entire life's savings, our credit, and now probably our house, which was used to secure the loan, and it didn't have to be that way. Timing worked against us. If we had a little more time we could have stayed in business, become profitable again, and avoided laying off 25 full-and part-time employees. So Senators, please consider ways to help small businesses like mine have a fighting chance to stay in business.

Thank you. I am happy to answer any questions.

Senator WHITEHOUSE. Thank you, Ed. That was incredibly important testimony and I appreciate that you have come here to deliver it.

[The prepared statement of Mr. Mendenhall appears as a submission for the record.]

Senator WHITEHOUSE. The next witness, Charles Bullock, is a day-to-day practitioner deeply engaged in the practical situations of debtors and secured and unsecured creditors in our Michigan bankruptcy courts.

Mr. Bullock.

STATEMENT OF CHARLES D. BULLOCK, ATTORNEY, SOUTHFIELD, MI

Mr. BULLOCK. Mr. Chairman and members of the Senate Judiciary Subcommittee on Administrative Oversight and the Courts, my name is Charles Bullock. I am a practicing attorney and founder of the Michigan-based law firm, Stevenson & Bullock, PLC. I am licensed in both Michigan and Tennessee. My practice concentrates on individual and small business bankruptcy cases, representing trustees, creditors, debtors, and other interested parties in Chapters 7, 11, 12 and 13.

My substantive comments are premised on the firm belief that there must be an alternative to the current process set forth in Chapter 11 when a small business seeks relief in bankruptcy and attempts to reorganize. I do not, however, believe that such an alternative would require one to revisit the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

I agree with those who have called on this body to refrain from reflexive legislative efforts which do not afford a wholesale solution, particularly the comments of the well-respected jurist, Hon. Thomas B. Bennett of the U.S. Bankruptcy Court in the Northern District of Alabama, who, during his December 5, 2007 testimony before the Senate Committee on the Judiciary, when discussing the looming foreclosure crisis, stated, "I am here to urge caution and restraint in doing anything which attacks what is only a portion of a greater problem". I strongly agree with that premise. Caution and restraint must be implemented in doing anything which attacks what is only a portion of a greater problem.

I hold a view that seems to be shared by all experts in the field, whether they are for or against a piece of legislation, which is that

any legislative solution should attempt to address the entire problem. With that in mind, I strongly support amending Chapter 12 to accommodate small business enterprises seeking to reorganize.

It is my firm belief that the immediate and long-term benefits of such Chapter 12 accommodation would address more than a portion of the greater problem and would provide little risk to those you desire to assist and to those many more not contemplated to be affected by the proposed legislation.

This solution benefits everyone involved in bankruptcy. It continues the business operation, retains jobs, and enables creditors to be paid. This is a commendable attempt to attain balance and increase the potential benefits of a reorganizing bankruptcy case. As the Subcommittee is aware, reorganization in bankruptcy is attained through Chapters 11, 12 and 13.

The U.S. Bankruptcy Code provides that a debtor that is not an individual may not be a debtor under Chapter 13 of Title 11. Stated another way, only an individual may be a Chapter 13 debtor. Furthermore, only a family farmer or family fisherman may be a debtor under Chapter 12.

Because of these restrictions, debtors engaged in business that are not eligible for relief under Chapter 12 or 13 that seek to reorganize in bankruptcy are required to file for relief under Chapter 11, regardless of size, amount of revenue, or the amount of the creditor base.

Insurmountable challenges are often imposed on both creditors and debtors when a small business seeks relief in the existing Chapter 11. Significant impediments to successful reorganization under Chapter 11 include, among other things, the high costs, balloting, and the lack of a standing trustee.

If the goals of the bankruptcy process are to provide a structured environment supervised by the court in which financially troubled companies may remain in business, continue to provide and create jobs, and restructure and retire debt, Chapter 11 fails miserably in addressing small business issues.

I have represented or closely interacted with nearly every party in a typical Chapter 11 reorganizing case. My experience dictates that Chapter 11 obligates debtors, creditors, and equity security holders to invest limited resources in the technical legal process rather than allowing the parties to specifically allocate those resources to the substantive reorganization efforts.

In the best legislative solution, a reorganization of a small business would assist the debtor and ensure that the debtor attends to the critical components of the case. That legislative solution would promote expediency, which is essential for small business cases to succeed.

I have marveled at the efficiency of the Chapter 13 process: the modest administrative expenses in Chapter 13, in relation to Chapter 11; the usefulness of a standing trustee; and the benefits inuring to both debtor and creditors once a plan is confirmed. As a result, I am convinced that Chapter 12 is a good fit for the small business debtor.

The Chapter 12 requirements of Section 1222 relating to the contents of a plan, Section 1225 relating to confirmation of a plan, are well-suited for traditional small business debtors. These provisions

are quite similar to Chapter 13 requirements of Sections 1322 and 1325.

In light of the cumbersome nature of Chapter 11 and the fragile nature of many small business debtors, the resulting lower administrative expenses incurred by a debtor in Chapter 12 recommend this alternative. So, too, creditor costs would be lower in Chapter 12. Balloting and unsecured creditors committees will give way to an independent and disinterested Chapter 12 standing trustee who would represent the interests of all creditors.

Inasmuch as feasibility is a condition of confirmation in Chapter 12, a judicial gatekeeper will have a better ability to maintain its docket and the integrity of the bankruptcy system by confirming, converting, or dismissing these cases. In the Eastern District of Michigan where I practice, we have an exceptionally diligent, albeit extremely overworked, court.

In his opening statement, the Ranking Member has made an insightful comment about zombie banks. Similarly, Chapter 11 seems to have the unintended consequence of creating zombie debtors because of the administrative process and impediments to confirmation. Chapter 12, however, requires that the court specifically address feasibility, which is something not required in Chapter 11. As a result, this may better address the problems of such debtors.

Thank you.

Senator WHITEHOUSE. Thank you very much, Mr. Bullock. I appreciate your testimony and that you've taken the trouble to come here and join us.

[The prepared statement of Mr. Bullock appears as a submission for the record.]

Senator WHITEHOUSE. Our next witness is Judge Small, who was really, I gather, present at the creation of Chapter 12 as one of the draftsmen who assisted Senator Grassley when he prepared that piece of legislation.

Without further ado, Hon. Thomas Small.

STATEMENT OF HON. A. THOMAS SMALL, U.S. BANKRUPTCY JUDGE, RETIRED, EASTERN DISTRICT OF NORTH CAROLINA, CO-CHAIR, NATIONAL BANKRUPTCY CONFERENCE, SMALL BUSINESS WORKING GROUP

Judge SMALL. Thank you, Mr. Chairman and Senator Sessions, for inviting the National Bankruptcy Conference to testify this morning.

Before I retired in September of last year, I was a Bankruptcy Judge for the Eastern District of North Carolina, and most of my Chapter 11 cases that I handled were small businesses.

What I saw from the bench is consistent with the testimony of Mr. Mendenhall and Mr. Bullock. Chapter 11 does not work well for many small businesses, and unfortunately for some debtors like Mr. Mendenhall, it does not help at all.

Professor Ed Morrison of Columbia Law School and I are co-chairs of a National Bankruptcy Conference Working Group to recommend ways to remove some of the obstacles to reorganization. In my written testimony is our report.

At first, we considered a separate chapter for small businesses, much like Chapter 10 legislation supported by Senator Grassley

and Senator Hefflin from Alabama in the early 1990's, but we finally realized that a better solution would be to allow small businesses to file for relief under Chapter 12, a time-tested chapter of the Bankruptcy Code that has been extremely successful in enabling family farmers to reorganize. Small businesses face many of the same obstacles that once confronted family farmers.

If Senator Grassley were here today, he would see that my testimony is very similar to the testimony I gave almost 25 years ago on the national farm crisis at a hearing chaired by Senator Grassley and Senator John East. Today, the crisis facing small business is just as dire and the solution, in our opinion, is the same: Chapter 12.

The problems confronted by distressed small businesses are numerous. First, Chapter 11 was designed for large corporations and it's very expensive. Most of these costs are professional fees. As a judge, I tried to reduce these by streamlining the Chapter 11 procedures, but the problems extend far beyond that. In Chapter 11, costs must be paid in full at confirmation, and this is a very heavy burden for cash-strapped debtors. Chapter 12, though, allows administrative costs to be paid over time.

Especially troublesome are Chapter 11's high voting requirements, the Absolute Priority rule and restrictions on downsizing through the sale of assets. These give secured lenders an undue influence over a debtor. Chapter 12 eliminates these obstacles. There's no voting, there's no Absolute Priority rule, and there are no restrictions on selling assets to downsize a business.

Another virtue of Chapter 12 is that it makes small business cases subject to case monitoring. In every Chapter 12 case there is a standing trustee who gives impartial oversight, examines the debtor's affairs, makes recommendations concerning plan confirmation, mediates disputes, and monitors plan compliance.

As Mr. Bullock said earlier, this is a great benefit to creditors. Another benefit to creditors is that a reorganization preserves the going-concern value of collateral, which is always higher than what a secured creditor receives from a liquidation. Moreover, creditors receive a prompt confirmation decision because Chapter 12 moves fast. There are no zombie debtors in Chapter 12. Plans must be filed within 90 days and confirmation hearings take place 45 days thereafter. Chapter 12 cases that are not viable are quickly dismissed.

Now, it is true that secured lenders may not be happy giving up their right to vote, but under Chapter 12 they always retain the right to object to confirmation of the plan. Chapter 12 debtors must pay all of their disposal incomes to creditors. All plans must meet strict confirmation standards and they must survive the scrutiny of an independent trustee.

The need to address impediments to small business reorganization is urgent. Delay in enacting the legislation will deny a fair chance to reorganize to thousands of financially distressed small businesses. There is no time or need for further study.

Now, this is what I know from my experience. In my district, between 1986 and 1999, there were 354 Chapter 12 cases filed. Seventy-seven percent of those family farmers had their plans confirmed, and 50 percent of all of the family farm cases were success-

fully completed. It's actually better than that because a lot of the cases that were dismissed were dismissed because they entered into arrangements with their secured creditors and they didn't need Chapter 12 anymore.

But Chapter 12 has worked well for family farmers. It is the considered view of the National Bankruptcy Conference that it will work well also for small businesses. Thank you.

Senator WHITEHOUSE. Thank you, Judge Small. We appreciate your testimony very much.

[The prepared statement of Judge Small appears as a submission for the record.]

Senator WHITEHOUSE. Dr. Mason is the Louisiana Bankers Association Chair of Banking at LSU, which brings him up here from Tiger Stadium, a place I have been, and appreciate very much that you've come. I particularly appreciate your closing remarks that "a leaner system with simplified filing and streamlined procedures for quick recovery will help those who have the capacity to get back to business while preserving collateral value and saving on legal bills for others. Such a system has the potential to be an important impetus for economic growth in the coming recovery", which is the premise of this hearing, so we are grateful that you're here.

Dr. Mason.

STATEMENT OF JOSEPH MASON, ASSOCIATE PROFESSOR, DEPARTMENT OF FINANCE, LOUISIANA STATE UNIVERSITY, BATON ROUGE, LOUISIANA

Dr. MASON. Well, thank you. I will try to buildup to that conclusion and reemphasize that remark. But thank you, Chairman Whitehouse. Thank you, Ranking Member Sessions, for inviting me to testify on this very important topic today.

I'm an economist. I have a little different point of view than many of the attorneys and judges on the panel. A well-designed bankruptcy law, to me, is a crucial stabilizer to economic growth. Since the times of Thomas Jefferson, the idea has been that the uncertain nature of the farm business deserves special consideration.

Such treatment was accompanied by restrictions on financial institutions that lent money to the farms so that those institutions would be so undiversified, as well as legally hobbled in bankruptcy law, that they had no alternative but to forbear on farmers in times of poor harvests.

As the U.S. economy grew and as industrialization took hold the traditional family farm became considered a small business, so in some ways it looks sensible to allow small businesses to use Chapter 12 as a new bankruptcy alternative. Unfortunately, the present approach focuses on preventing bankruptcies rather than facilitating them. As a result, the approach under consideration will hurt both economic growth as well as small business owners.

One of the main problems in small business bankruptcies is that small business and personal assets and liabilities are often commingled. It is hard sometimes to see where the boundaries of personal lives and business lives exist, especially in small businesses. One simple example is the prevalence of small business subprime home lending that played a part in the run-up to the recent crisis.

One such firm, American Business Financial Services, was the subject of a spectacular bankruptcy and fraud allegations in the Philadelphia region. I argue that it is those boundaries between the personal and the business obligations that lead to the most disruptive losses in small business bankruptcy. The causes of small business bankruptcy and personal bankruptcy are also commingled.

While many studies seek to categorize the causes of small business bankruptcies, the chief risks are cash-flows and lawsuits and what we call key man risk. Cash flows and lawsuits speak for themselves. Of course, a skilled manager can help guide a business through the minefield, but the skilled manager is often the owner or managing partner. Without him or her, the business cannot stand.

Consider, the chief risks facing the key man here in the operation are the same personal financial shocks that cause personal bankruptcy: divorce, automobile accident, health care crisis, and addictive disorders. So we know there's a problem. Small business bankruptcies are not like large business or personal bankruptcies. But while change may be necessary, change is costly.

We are still dealing with the fallout of changes to bankruptcy incentives in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Liberal rights granted to unsecured consumer creditors under the Act are understood to have led to increased credit supply and rampant consumer borrowing.

On the business side, the Act's extension of safe harbor provisions led to failed firms being drained of cash and assets by margin calls on new financial products, leaving the firm a mere shell in the aftermath of the recent crisis.

Similar dramatic changes occurred with the implementation of Chapter 12 when agricultural experts noted that even major suppliers of fuel, seed, fertilizer, and chemicals were forced into Chapter 7 liquidation as a result of their customers' treatment under Chapter 12, a manifestation of what today we term "systemic risk."

Each time we tinker with bankruptcy laws we impose significant costs on all economic agents. We all know the classic tradeoff. Empirical results have shown that higher personal bankruptcy exemptions are associated with more business ownership, but higher personal bankruptcy exemptions are also associated with increased credit rationing and higher interest rates.

The challenge before us, therefore, is not to figure out how to prevent bankruptcies. Rather, the challenge is to craft a small business bankruptcy law that can be used. If that's what we seek, then Chapter 12 is probably not the answer. Empirical evidence also shows that very few farmers actually use Chapter 12 and that bankruptcy relief has not, and cannot, halt the decline in family farming. It won't save small businesses from a recession either.

From an economic point of view, therefore, we want a small business bankruptcy law that smooths the transition of the serial entrepreneur, allowing them to flow into and out of businesses in a way that preserves both creditor and entrepreneur value. Economically, the simple key to retaining that value is to intervene earlier than is currently the case; of course, that means more bankruptcies. But as authors noted even before the 2005 Act, the sur-

prising aspect of at least personal bankruptcy, which has been researched in this way, is not how many people use it, but how few.

So overall, a leaner Chapter 11 system with simplified filing and streamlined procedures for quick recovery will help those who have the capacity to get back to business, while preserving collateral value and saving on legal bills for others. Moreover, such a system has the potential to be an important impetus for economic growth in the coming recovery. Simplistically extending Chapter 12, however, in the manner proposed will not realize that crucial potential.

Thank you.

Senator WHITEHOUSE. Thank you, Dr. Mason. We appreciate your testimony.

[The prepared statement of Dr. Mason appears as a submission for the record.]

Senator WHITEHOUSE. Our next witness is the distinguished Judge Bennett from the Bankruptcy Court of Northern Alabama. If I could take the liberty of highlighting one of his conclusions, it is that it is, and has been clear for decades if not longer, that Chapter 11 of the Bankruptcy Code does not allow some businesses to reorganize their financial affairs in a timely and efficient manner and at a cost that is affordable. He has great experience in this area and it is very helpful to us.

We look forward to your testimony, Judge Bennett.

STATEMENT OF HON. THOMAS BENNETT, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF ALABAMA, BIRMINGHAM, ALABAMA

Judge BENNETT. Thank you, Mr. Chairman.

Let me start off by saying that the right of failure—that is, failure—is essential to our economic system. To the extent that we change statutes—and in my view some of the 2005 amendments to the Bankruptcy Code did something counterproductive—where we either eliminate the right to fail or we delay the right to fail, what happens is a misallocation of our resources that is detrimental in the long run to everybody at the benefit of a few.

So what I think needs to be paid attention to is the bigger picture here, and that is, we do not want to create a disincentive for failure. The best example, if you want to look at the best example in recent history, is the inability to fail in some of the Eastern bloc countries of Europe, and their economic troubles were the result of not being allowed to fail.

So in the context of the bigger picture, we need to structure something that does something that is efficient for our system. That means it should be a system that allows failure to occur when it should occur much more quickly than bankruptcy frequently does. At the same time, it needs to allow reorganization and identify those businesses that can successfully reorganize in the long run much more quickly.

To give you a good example, Mr. Chairman, you talk about preserving jobs, but there is a price. If you preserve jobs that should not be preserved, you lose other jobs. Let me bring it a little bit more home to you. You are familiar with Thayer Street in Providence. Great dynamic little street, tons of little businesses there. And as you're aware, they frequently go out of business.

If you allow businesses to drag out, what's happens is a slow demise: inventory gradually decreases, jobs gradually decrease over time. When, if it was efficient and that business ultimately fails a year or two later and the delay is caused by a bankruptcy process, if it were efficiently done the business is replaced, more people are hired. That's really the tradeoff and why it is very critical, when you do something of the nature that's proposed, that you have to look at those sorts of dynamics.

The bigger picture of what's proposed is, and the data is, that what we are going to do under the proposed version is move somewhere between about 7 to 95 percent plus of all current Chapter 11s and make available Chapter 12. I think there's a definitional problem. I think that the liability side alone at $10 million is far too high because, on the data I've supplied to you, you can have at least $3 billion entities in small businesses under definition in 2009; 300 and some-odd cases with assets of over $10 million would have been small businesses. Under the definition, there is a law firm in this country that has no debt that has well over 700 lawyers, thousands of employees. There are companies that are very large companies that would comply.

When you realize that the structure of the definition causes a vast expansion and shifting of bankruptcy potentially from Chapter 11 to Chapter 12, and that Chapter 12 does present creditors and other interests further risks than they would otherwise face in Chapter 11, the market is going to react to this. What you don't want to do is cause a market to decrease the supply of credit, for instance.

That's the bigger picture here and the difficulties I have with Chapter 12. It is not that we shouldn't do something for small businesses, but the question becomes: what is a small business? Is it a business that's a mom-and-pop grocery store? Sure it is. Is it an entity that has 3,500, 1,000, 2,000 employees? I think that at some point you have to really keep it at small businesses.

There are structural changes from going from an 11 to a 12 that implicate, with a lot of the entities that would otherwise under the definition of a small business in this Act, changes that I don't think Congress contemplates. Do you want them to, for instance, be able to reject union contracts and not have the same protections that unions have in a Chapter 11? I don't know that that's contemplated. But that's the bigger picture.

A couple of quick, minor points. If this were enacted, there are four vehicles for small businesses, very small individual cases in 13, the new Chapter 12, the small business portion of 11, and a Chapter 11. It's too complex. You ought to have one provision that governs small businesses.

My suggestion is, you don't put it in Chapter 12. The reason is, I used to get paid to do amendments and it is very complex and very difficult not to make a mistake because you can't think in advance of all the interrelationships. It ought to be separated. Don't mess with the family farmer provisions that people think work, and like. Put them somewhere where it won't mess up those provisions, for want of a better term.

I think that we need to restrict it to truly small businesses, not very large businesses. We need to understand the broader implica-

tions, which include potentially causing interest rates to rise if it's not done right because of higher systemic risk to lenders, which means potentially less business and less employment. I think that the small business provisions need to be moved to maybe a new chapter, or within the Chapter 11 provisions.

My time is up, so I am going to quit.

[The prepared statement of Judge Bennett appears as a submission for the record.]

Senator WHITEHOUSE. Well, I'm not going to let you quit because I'm very interested in your testimony. So I'm going to start with my question right back to you to continue the discussion that you've so ably participated in. I'm going to unpack a few questions. Is there any harm to the fishermen or farm owners who presently enjoy the benefits of Chapter 12 if its rules are expanded also to small businesses? Are they hurt by doing that or do they just continue on?

Judge BENNETT. To answer your question simply, the answer is no, not on the surface. The problem is this, that when you amend a statute there are interrelated provisions. Lawyers, unfortunately, and judges use words. The reason scientific methodology was developed, is they use mathematics. Mathematics are far more precise in analyzing and avoiding problems.

Words are highly imprecise. I might focus on drafting a statutory provision thinking about small businesses and not contemplate that what it may do is cause future problems in the context of other types of businesses. It's not that on its face it is an issue, it is that there may be legal issues that come up in the future, and why take that chance at the expense of farmers and fishermen?

Senator WHITEHOUSE. So your concern would be that as the courts adjudicating Chapter 12 proceedings dealt with small business bankruptcies, they would make Court of Common Law changes in the way they did business to accommodate this new kind of customers.

Judge BENNETT. Could be.

Senator WHITEHOUSE. And that would reflect back onto the farm owners and fishermen.

Judge BENNETT. Could be.

Senator WHITEHOUSE. OK. You can see that we need to make Chapter 11 more efficient for small businesses. I think everybody on the panel agrees with that proposition, that it is now failing them. Does the general Chapter 12 rubric of having a standing trustee and having a confirmation plan that has to be filed and approved relatively rapidly for trying to resolve the business on a going-forward basis provide the template for what should be done with a small business bankruptcy provision, assuming that we've correctly defined small business and eliminated the sort of definitional errors that you've described?

Judge BENNETT. The answer is, if you understand the difference in the dynamics between a Chapter 11, which is structured to be consensual, and if not consensual there are some methodologies that you can use to have a case confirmed, versus a Chapter 12 which is not consensual.

It basically means, the difference is that in a Chapter 11, if you get a plan confirmed, you are essentially trying to get the partici-

pation of unsecured creditors, and secured. The difficulty in a Chapter 12 is that that's not the case. It's structured so they receive, theoretically, the indubitable equivalent of what they had as a secured creditor as of, in this case, the confirmation hearing.

The difficulty that people may not understand is that in Chapter 13s and 12s, unsecured creditors can get nothing. It is not that unsecured creditors receive full payment or partial payment. It could be any of those. That dynamic difference between an 11 and 12 is this, that unsecured creditors may not want that particular type of plan. Frequently, the chief unsecured creditor can be, particularly in small cases, the secured lender too whose collateral is at risk on the future ongoing operation.

So with respect to some businesses, depending on the definition of small, the dynamic of Chapter 12 is basically a forced confirmation, with the risk being mostly on the value of the secured creditor's collateral and the unsecured creditors may effectively, if the estate otherwise would have had money to pay, not get paid anything.

Senator WHITEHOUSE. I would be interested in your reaction to this observation, which is that that may not necessarily be a bad thing.

Judge BENNETT. Correct.

Senator WHITEHOUSE. The experience of a great number of debtors, mortgage holders, is that banks have become very difficult to work with. In this day and age you spend an enormous amount of time waiting on the phone and punching through the numbers and trying to find somebody who actually has your file and can make a decision, and it's sort of been bureaucratized to the point where it's incredibly frustrating, at least for Rhode Islanders who I talk to, to deal with their creditor, particularly the bank or a secured creditor, whenever they have a problem.

So to me, having a neutral disinterested trustee who can make a sensible business decision and enjoys the confidence of the court is a better decisionmaker than to leave that poor debtor to the tender mercies of the secured creditor who has their secured creditor work-out shop grinding through this stuff and treating them as basically grist for the mill, and what they want to do is grab whatever they can, sell it as quick as they can, cut their losses, and move on with very little consideration for the well-being of the business itself, or its employees, or the larger community.

Judge BENNETT. I don't think that's necessarily the case. There are good and bad in all situations. There are good bankers, there are bad bankers. There are good bankruptcy practitioners, there are bad bankruptcy practitioners. People don't shoot themselves in the foot knowingly.

I will tell you, for instance, today, that what I see in the mortgage context is that bankers want to take back properties where they're over-secured and they are perfectly willing to renegotiate where they're deeply under water. The same thing sometimes holds true in the business world, but bankers are not necessarily the evil side of this.

Failures are failures. They are failures for a reason. You need to look at why the failure occurred. The idea that a trustee who is almost universally a lawyer—and I would suggest to you that law-

yers are not very good businessmen. I'm sorry, but they aren't. They're not trained in it. That's not what we focus on.

The idea that a lawyer, which is the predominant number of trustees, has the business abilities on some businesses with $10 million in debt and hundreds or a thousand employees, I would suggest to you that that's not necessarily the people you want looking at it. You want people that have business expertise. They're not necessarily dispassionate.

If you understand how Chapter 13 and 12 trustees are paid, they're paid by a percentage of assets that roll through the trustee's accounts to pay out to people, so there is an incentive to let them potentially last longer than they should. My experience, though, is that most trustees try to do a good job. They're not business people. They look at the technicalities of the Bankruptcy Code and they look at the technicalities of whether you're following your plan as distinguished from being able to do business analysis.

Senator WHITEHOUSE. My time has expired. Let me turn to the distinguished Ranking Member.

Senator SESSIONS. Thank you. Let's follow along with that. Mr. Bullock, you've represented parties on both sides and you've heard Judge Bennett express reservations about Chapter 12. I know you could talk about that for my whole 5 minutes, but what are your thoughts? I'll just give you a chance to respond to that.

Mr. BULLOCK. Thank you, Senator. I do take issue with the idea that an independent fiduciary, a standing trustee, is not suited or up to the task. As this Subcommittee knows, the Office of the U.S. Trustee is charged with certain duties, including appointing a panel of trustees. My experience has been that not only are they generally exceptional practitioners, but they are either skilled or become skilled in whatever tasks they're responsible for. The one thing, though, that I know about the trustee system is there is the opportunity to retain experts.

Senator SESSIONS. Now, is there a difference in the role of the trustee in Chapter 12, the farming chapter, as opposed to Chapter 11?

Mr. BULLOCK. Yes. In context, we generally don't see a trustee appointment in a Chapter 11. There are times: malfeasance, fraud, basically getting the debtor out.

Senator SESSIONS. So one of the big changes—I'm just getting this in my head. One of the big changes if you go to 12, you'll have a trustee in every case?

Mr. BULLOCK. No different than you would in a Chapter 13 case, where there is a standing trustee who is a fiduciary, has defined responsibilities and, again, from my perspective, benefits the system a great deal because of their independence.

Something else that I would like to point at, and this is an observation being on all sides of the table in Detroit, is that the creditors' bar, as tasked as the debtors' bar is currently, their clients, frankly, don't necessarily know what to do with the collateral that they have and often, inreflexively, they simply liquidate it, not because they're trying to be difficult, not because they're trying to be nasty or mean or do anything that would affect the debtor for any reason other than, they just don't want to hold onto the property.

Senator SESSIONS. But the question to me would be, what do you do with the property? If the creditors who presumably loan money and are into this company pretty deeply can't see any viable way for it to be successful, maybe they're better than a trustee in making that decision.

Mr. BULLOCK. Respectfully, Senator, I believe that through the Chapter 12 process, what we have is something called feasibility, which is really important. In Chapter 11, there is not a feasibility requirement. The judges, our courts, don't have the defined role of looking at the plan and saying, is this or is this not feasible. In Chapter 12, they do.

So looking at a 90-day window where a plan has to be in, where in Chapter 11 you're well north of 100 days, I believe that because the judges are looking at feasibility, and because under a case that's called Rash, it's a Supreme Court case that talks about how we value collateral, we look at a part of the Bankruptcy Code.

And to leave the Code sections out I'll simply say you look at the Code and we're looking at, rather than liquidation value, which is I think the lowest value, we're looking at, how are we using the collateral, the intended use of the collateral, which is a higher value, and then the courts are charged with determining what the value is. I've read in some of the material, there was a thought that maybe judges aren't well-suited to do that.

Respectfully, our Supreme Court has said that's exactly what they're supposed to do, and I for one, speaking only for myself, would say if there's a bankruptcy judge in the United States who is not capable of valuing collateral, I would encourage whoever is responsible for that judge to remove that judge. That's their job.

Senator SESSIONS. Well, Judge Small, I'll let you—now, the Bankruptcy Conference, which you're speaking on behalf of, or at least their analysis, favors the Chapter 12 solution. The National Bankruptcy Review Commission does not. But are there ways—is it important to you that it be precisely adopting the Chapter 12 route, or could there be a reform of Chapter 11, as I understand Judge Bennett to be suggesting?

Judge SMALL. There could be. That's how it started out.

Senator WHITEHOUSE. Your microphone, Judge Small. I'm not sure it's on.

Judge SMALL. That's how we started out. As I said, we thought about a separate chapter, but the more we thought about it, we realized it was modeled on Chapter 12, why not do Chapter 12? We've go the body of case law, we know it works. I mean, it works really well.

If I could follow up on just one thing that Judge Bennett said about the consensual plans, there are no consensual Chapter 12 plans. That's not exactly true. The creditors have the right to object to confirmation. They don't vote, but they do object to confirmation. That's what happened in Chapter 12 cases, they would object. The Chapter 12 trustee then would bring the parties together, and most of our Chapter 12 cases were consensual plans. They resolved the objection and worked out a way that was satisfactory to both the creditor and the debtor. So, I just wanted to make that point.

Senator WHITEHOUSE. Thank you. I think we may go back and forth for a while, because I think this is an issue of interest to both of us.

Mr. Mendenhall, let me ask you a specific question about your situation. Do you believe that if you had had the opportunity to reorganize your business based on the way it was going, your customer loyalty, and all that, that you would have been able to continue successfully and pay back your creditors in full?

Mr. MENDENHALL. Yes. Absolutely. We had the history behind us. We had already been in business for over 10 years at the time we started the relocation. With the relocation, we had a brand-new facility that was almost twice the size of our original facility. So, everything was just all the better. So, absolutely. We just needed that time to regroup from that eviction and that whole process there.

Senator WHITEHOUSE. And the cost, as you have said, of the fact that the system could not accommodate you in that way has resulted presumably in fairly significant losses to your creditors and having to——

Mr. MENDENHALL. Yes. Absolutely. It totaled over $1 million. Yes.

Senator WHITEHOUSE. And in addition, your own credit, your own savings, and potentially your own home are also lost.

Mr. MENDENHALL. Yes. Exactly.

Senator WHITEHOUSE. So, pretty considerable economic devastation around you, all for what one might call the want of a nail to keep the process supporting your business.

Mr. MENDENHALL. Exactly. Yes.

Senator WHITEHOUSE. OK. And is that what—I'll ask, I guess, Judge Small first. But both you and Counselor Bullock referred to the benefits inuring to creditors from moving to a Chapter 12-type model. Could you elaborate on what you meant by benefits inuring to creditors, and is it Mr. Mendenhall's situation?

Judge SMALL. I really think there are a lot of benefits to creditors, and primarily it makes reorganization easier. Reorganization has got to be better where that secured lender gets the going concern value of the property rather than a liquidation value. If you're looking at those two alternatives, liquidation value is always lower than a reorganizational value.

I think the Chapter 12 trustee brings a lot to this procedure. I mean, it's monitoring. Unsecured creditors don't participate in Chapter 11, small business Chapter 11 cases. There's a provision that says there should always be a Chapter 11 creditors committee. There's never a Chapter 11 creditors Committee in small business cases because you can't get the interests of the small business—the small businesses that are the creditors. You can't get them to vote, even though they would support the plan. I'm sure Mr. Bullock can speak to that, but it's almost impossible to get creditor participation in these small business cases.

That's why it's so important to have a Chapter 12 trustee to monitor, to make recommendations to the court: is this business feasible? If it's not, it's not a zombie debtor, we get the debtor out of the system. But if there is a chance of viability, then you have this trustee monitoring what goes on and he monitors after con-

firmation to make sure the debtor does what the debtor has promised to do in that plan.

Senator WHITEHOUSE. And Mr. Bullock, you represent both secured and unsecured creditors. What's your thought on the benefits inuring to creditors from reform?

Mr. BULLOCK. I'm in agreement with Judge Small, and I'd like to make an observation. I enjoyed the material that all of the parties submitted to this body. One of the things that I—one of the packets that I enjoyed the most was Dr. Mason's. Within that, there is a footnote, it's footnote 5, and it brings an article from 1989 to our attention called "Chapter 12 and Farm Bankruptcy in California."

If you take that article, which is really at the height of when this family farming crisis was and it was coming to an end almost, and you look at Judge Small's material, where there's a graph on page 14 which shows, back in that time line we have filings up here, and then all of a sudden they taper down quickly, I mean, like a bullet, straight down. We have to ask ourselves, why? What was it that debtors and creditors were doing differently?

I think what happened is, on page 29 of the article, someone played Nostradamus and said one might expect, as more information becomes available on the court's interpretation and implementation of Chapter 12 regulations, farmers and lenders will increasingly turn to privately negotiated reorganizations to avoid the administrative costs of a formal bankruptcy proceeding. The pattern of filing lends some support to this hypothesis.

I think what happens, and whether it's intended or unintended, is if we have a process like this, the reason we're not seeing an awful lot of work going on in the bankruptcy courts is because the parties figure out, here's what's going to happen, here's what should happen, and in Chapter 12 we have some evidence that that's what did happen. People starting working outside of court rather than in court, and I for one—at least I submit to this body—believe that's a better way of handling these things. But until we get there, I think this Chapter 12 fit works.

Senator WHITEHOUSE. Judge Small, do you agree with Judge Bennett's concerns about the manner in which small business is defined, and would you be willing to work to make the definition more specific so we're not getting the sort of huge cases that he suggested that seem to be a misfit for this process?

Judge SMALL. Absolutely. The $10 million number was somewhat arbitrary. I think it could be lower. I don't think it ought to be any lower than $5 million. That was the number that the Bankruptcy Review Commission recommended. I, frankly, don't know where that number should be. If you overlay $10 million on the Administrative Office's statistics, I think it would show that like 77 percent of the Chapter 11 cases that were filed last year in 2009 would qualify for Chapter 12. Maybe that's too high, but I think maybe $5 million or $7.5 million. Unfortunately, when the AO collects that information there's a big gap: they have $1 million to $10 million. It doesn't draw the distinctions between what would happen at $5 million or $7.5 million.

Senator WHITEHOUSE. Senator Sessions.

Senator SESSIONS. Well, Dr. Mason, just briefly, anything that significant impairs the priority and the security right of a secured creditor is likely, is it not, in an economic sense, to cause lenders to be less likely to lend to any business and/or charge higher interest rates if they do so?

Dr. MASON. Disentangling that is a little bit tough because the value, the reduced value to one set of lenders, for instance, does not just disappear economically. It would go to another set of lenders or the borrower. That is part of what we've seen here in Chapter 12. Some of the problems that have arisen in Chapter 12 have arisen because Chapter 12 is specifically designed for a unique kind of small business that has a single large fixed asset that's an input to production, and because of that application, Chapter 12 doesn't exactly generalize.

I think that the discussion we've had here is extremely valuable because I think we all agree that some factors of Chapter 12 do provide a template, in particular, the speed of moving through the process, the certainty.

Senator SESSIONS. I'm kind of being self-limited here, but as a matter—if you sign a mortgage that gives you a guaranteed right upon failure to pay to take the property back, and that is eroded significantly through a bankruptcy rule change, does that ripple through the system, as some have told us in the past, and make lenders more nervous about lending and therefore rates could go up for everyone? Is that the economic sense of it?

Dr. MASON. Very much so.

Senator SESSIONS. Now, Judge Bennett, do you think that the Chapter 12 procedure that's been suggested here, does that erode any in any noticeable way the security rights of the lender who's got a secured mortgage?

Judge BENNETT. Bankruptcy impacts on security rights regardless of the chapter. To the extent that a procedure such as Chapter 12 is faster in identifying the failures and the successes, it can improve the process. To the extent, though, that it pushes through failures that should not be pushed through and it is easier in the context of the 13s and the 12s because they are so quick to push through failures, you could have a negative impact on the collateral value because of delay and the stretching out of the creditor during the course of the plan if the entity ultimately fails. So the answer is, it really depends on the context of the case and the context of what's going on, but the answer is, yes, it could.

Senator SESSIONS. Well, if you did this through Chapter 11, and you've expressed concern about cost and speed, I think you're exactly correct—exactly correct—to say, as decisively and with as much clarity as possible, the decision needs to be made that a company has a chance to succeed or it does not. Would you agree, that's a high priority of small business reorganization?

Judge BENNETT. I think, big or small, the quicker we identify the failures and let them fail, it improves the process and it furthers our economic interests.

Senator SESSIONS. And so that being the case, do you think that could be achieved more with reform of Chapter 11 than going to Chapter 12? Obviously you and the National Bankruptcy Review

Commission apparently feels that way. Specifically, how could you make that occur, effectively? Any ideas for specific reform?

Judge BENNETT. I think you can adopt portions of what is in 12 and 13 on timing. I think there needs to be more looking at whether it should be consensual, less consensual, or non-consensual. The idea that you can object to a plan is significantly different than being intimately involved in forming a business plan. So, I think you can work with those aspects.

I got paid in private practice to amend statutes. I have amended a lot of statutes. It is a huge danger—I mean, I've done amendments on Uniform Commercial Code and other areas, some of the—a lot of banking-type of legislation in private practice.

What you don't think about when you're drafting these amendments is how it interrelates to 15, or 20, or 30, or 40 other areas because you're focused on what you're doing. That's why I have a bias against partial amendments to anything, and it's cleaner usually and less dangerous to go in and do something new in toto than it is to go in and modify existing provisions.

Senator SESSIONS. Well, thank you all for your thoughts on this.

Judge BENNETT. Senator, could I say one thing?

Senator SESSIONS. Yes.

Judge BENNETT. What we've done here today has looked at a process where we are absent critical data. If there's nothing else that could be done, there is a treasure trove of data that can be obtained off of bankruptcy filings if they are complete and they are inputted.

What we need so we don't have discussions on theories and ideas is to go in and collect data that is available if it is properly inputted and properly designed for retraction by non-lawyers. The design ought to be done by non-lawyers and non-judges, the people that know what it is we need to extract and how to extract it.

Lawyers and judges can participate, but we would no longer have some of what goes on in the discussions of mortgage reform, on the BAPSIPA reforms that occurred. A lot of things were said that were inaccurate, but you can't prove it other than by theory.

Senator SESSIONS. Dr. Mason, I see, nods his head to that. Well, who would do that?

Judge BENNETT. Who would do what? I'm sorry.

Senator SESSIONS. Who would identify what data you need and what entity could be involved in retrieval of it?

Judge BENNETT. Well, I think it's mostly in the realm of those that deal in economics, that may deal in other areas. I think you have to have people that could pinpoint how and what it is you want to do. That's really beyond—you know, I'm a slow country boy from West Virginia that moved to Alabama, and it's beyond my capabilities. But it really is a travesty, a major travesty, that we've had the ability for decades to accumulate valuable data that would give us insights into a whole range of things and we don't do it, and it's something we really should do.

Senator SESSIONS. Well, I just thank you.

Senator WHITEHOUSE. Let me just say that when Mountaineers starts talking about slow country boys, you'd better watch yourself.

[Laughter.]

Senator SESSIONS. I would say this.

Judge BENNETT. Well, I understand that you spent a little time in the Mountaineer State, Senator.

Senator WHITEHOUSE. I did. I did, sir, and I enjoyed it immensely.

Senator SESSIONS. Just briefly, to raise that point, what percentage of the individual bankruptcy filers in the Northern District of Alabama filed Chapter 13? Do you recall what that number is?

Judge BENNETT. It used to be about 70 percent-plus. In the last 5 years, it became about 60/40, and the trend is now going back a little bit more for 13s.

Senator SESSIONS. And that's quite different than most bankruptcy courts around the country. Some are—less than 20 percent are Chapter 13s, aren't they?

Senator WHITEHOUSE. Some of the areas are very low Chapter 13s and high Chapter 7s for individual bankruptcies. Correct.

Senator SESSIONS. I guess I'm making the point here, and this is driven by the lawyers for the creditors, judges don't make them normally going to——

Judge BENNETT. I think it may be, in some instances, driven by the debtor's lawyers, not necessarily the creditor's lawyers.

Senator SESSIONS. Excuse me. I mean the debtor's lawyer. The debtor's lawyers. They think that's best for the debtor, and the debtor will come out in a better position through that mechanism than through Chapter 7. All I'm saying is, that's odd. We've got the same law in every district, so there are some subtleties in all of this, there's just no doubt about it. How we maneuver a deal with the difficulties of bankruptcy law—I guess you've all warned us to be careful, Mr. Bullock, all the way through, as one that we should be careful about.

Thank you.

Senator WHITEHOUSE. Let me offer some closing thoughts as our time runs out. The first, is that I would appreciate very much, the hearing will stay open for—the record of the hearing will stay open for an additional week.

I read both Dr. Mason's testimony and Judge Bennett's testimony as recognizing substantial problems with Chapter 11 as a vehicle for small businesses that could reorganize but for the delay in cost and inefficiency of the Chapter 11 process as it presently is constituted, and you have reservations about Chapter 12 as a complete and adequate response to that problem, but you don't contest that the problem is a real and a significant one.

I would appreciate it if you would take a moment, if you would not mind, and put your thoughts in writing back to this Committee as to what positive changes you would recommend. It doesn't necessarily have to be in legislative-type format—I know, Judge Bennett, you've done statutory amendment before—but more from a policy point of view what you think are the key elements that would help facilitate reorganization of small businesses like Mr. Mendenhall's when they are in distress.

I take it, from everybody's testimony, there seemed to be some unanimous opinions. One is that there is a universe of small businesses represented here by Edward Mendenhall that are reorganizable and that could continue, and continue to employ people and be profitable, that Chapter 11 puts under because of the cost and

the delay and, some would argue, the secured creditor-driven nature of Chapter 11.

I think that's an important universe for us to keep our eye on in this process and try to find a way to improve the process to serve, and whether it's through Chapter 12 or through a modified Chapter 11, however, I think both of our minds are very open to that. But I think we're also both keenly interested in this problem of unnecessary small business failure driven by a Federal process and not by the underlying economics of the business.

So I look forward to continuing to work with all of the witnesses as we go forward on this process. I hope that you will not object if our staffs continue to be in touch with you as we try to work through these issues. I think this is important. I think this has been a valuable exploratory hearing and I look forward to persevering along these lines.

I would like to, without objection, ask for Senator Russ Feingold of Wisconsin's comments to be added to the record of the hearing.

[The prepared statement of Senator Feingold appears as a submission for the record.]

Senator WHITEHOUSE. I would like to recognize two important guests who are with us: Edward Mendenhall's wife Kim is with us, and has traveled down from Rhode Island. I'm delighted that she is here. And Chuck Bullock's son David has been with us, sitting patiently through all of these proceedings, and I appreciate that he has taken the trouble to come.

I look forward to continuing to work with all of you. Judge Small, what you and the Bankruptcy Conference have done, I think, is enormously valuable. I think that to me your focus on this has been commendable and much appreciated, and I think you are the core of the solution here and we really look forward to working with you as this continues.

I thank you all for your testimony and your participation in the hearing. As I said, the record will remain open for a week after this.

The hearing is adjourned.

Senator SESSIONS. Mr. Chairman.

Senator WHITEHOUSE. Yes?

Senator SESSIONS. I was going to offer for the record——

Senator WHITEHOUSE. The hearing is not adjourned.

Senator SESSIONS. Senator Grassley, who has expressed his concern about the addition. He says there are now 345 Chapter 12 filings and 10,000 Chapter 11 filings, so it would have a great impact on a Chapter 12 farmer in a bankruptcy proceeding that he, as one of the architects—the prime architect—of.

I would offer the International Council of Shopping Centers, who warned that this could have an immediate impact in terms of the credit crisis we're in. They have some specific concerns about a change like this, how it could cause concern. In general, they oppose it. I guess in many ways they are one of the more prominent creditors in so many of these cases of small business. Thank you. I would offer both of those for the record.

Senator WHITEHOUSE. Both will be accepted into the record, particularly Senator Grassley's comments will be accepted with great

interest because of his long experience in there, as you pointed out, as the architect of Chapter 12.

[The prepared statement of Senator Grassley appears as a submission for the record.]

[The letter from the International Council of Shopping Centers appears as a submission for the record.]

Senator WHITEHOUSE. As I said, I think we're at the beginning of a process here in which a great number of interests will be engaged, but I am confident that we can find a way through, given the universality of you that there is a substantial universe of businesses that are reorganizable, that fail unnecessarily due to the inefficiency of Chapter 11, and that that is something we're in a position to remedy.

So, thank you all very much.

We are adjourned.

[Whereupon, at 11:57 a.m. the Subcommittee was adjourned.]

[Questions and answers and submissions for the record follow.]

QUESTIONS AND ANSWERS

Written Responses to Questions from Senator Grassley by

Hon. Thomas B. Bennett
United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Alabama
Birmingham, Alabama

before
Senate Committee on the Judiciary, Subcommittee on the Administrative Oversight of the Courts

"Could Bankruptcy Reform Help Preserve Small Business Jobs?"

April 7, 2010

Chairman Leahy, Subcommittee Chairman Whitehouse, Ranking Member Sessions, and Members of the Subcommittee, I am setting forth my responses to questions from Senator Grassley regarding the proposal to amend certain portions of the Bankruptcy Code, 11 U.S.C. §§ 101 et seq., dealing with what are described as small businesses. As with my prior testimony, my answers to Senator Grassley's questions constitute my views, not those suggested to me by others. Furthermore, my responses are not made as a representative, member or officer of any group or organization.

Question 1. At the hearing, you expressed concerns about expanding Chapter 12 to small businesses because it "might mess up those provisions" that have worked well for family farmers and fishermen. Could you please elaborate in more detail your concerns about applying Chapter 12 to small businesses?

Response to Question 1. To cite to a specific application of just what might happen in the future should small businesses be able to utilize the provisions of Chapter 12 of the Bankruptcy Code is difficult to do before it occurs. In order to understand my concerns, one must know and understand the severe limitations on what lawyers and judges do. It is the analytical tool that lawyers and judges use, words, and the structural foundation for making decisions, case law extrapolation, that cause decisions of a court in one case to be applicable to many, if not innumerable, other legal and factual combinations never contemplated by the court making the first decision in a given fact and law context.

There is a reason why mathematics and other quantitative methods are utilized in disciplines other than the law. It is that it becomes very difficult, and ultimately impossible, to study a topic and its implications by using verbal analysis. Although up to a point, some very bright individuals may be able to manipulate multiple facts and laws to reach a "ruling" or

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similar legal conclusion, beyond some number of facts and applicable laws or legal principles, be it three or four or five or twenty or some other number of facts that vary as applied to multiple legal principles, a point is reached when one may no longer use verbal analysis.

In the belief that lawyers and judges may get around the limitations of verbal analysis, a method that is the opposite of what is done by use of mathematics and other quantitative methods has been developed in our legal system. Unfortunately, it is simply a bandage covering what is the bigger problem: use of verbal analysis to reach a legal conclusion will be inapt for many cases in the universe of relevant variations of laws to facts. Why this happens is the impact of our common law system where an initial decision by one court – particularly if it is an appellate court – governs all future cases perceived by the decision maker as being within the set of facts and law that are within the boundaries viewed as the same, or similar enough, to those of the case where the first ruling occurred. Recognition of this limitation is inherent in what lawyers and judges are taught to do in law school. It is to distinguish a particular matter from what would otherwise be the controlling precedent by either arguing that a fact or facts or another legal principle or principles make it so different from the governing case law that the governing case law should either be modified or not apply.

What is essentially being done is that one set of facts and one set of legal principles are by verbal analysis being used to make a rule in one case that by our system of precedent is applicable to all future cases within what is verbally perceived as the same universe of facts and law as the first case which set the governing law. Pictorially, this is looking at a glass ball with numerous marbles representing the perceived universe of relevant variations of facts and law and selecting one marble for making one's legal decision. Because this marble came from the glass bowl with, for instance, many iterations of facts making up the same universal set, the decision based on one marble with its fact pattern becomes the governing rule for all of the other marbles in the bowl with all sorts of factual variations. More simply, the first case governs all future ones viewed as similar until and unless one may distinguish the first ruling in a later case. Absent such modification or exclusion, the problem is that this method of legal analysis means that the first decision will be incorrect when applied to the fact patterns represented by other of the marbles in the universal set represented by the bowl.

As indicated, lawyers and judges use the technique of distinguishing by demonstrating a significant degree of variance in facts or applicable legal principles to take subsequent marbles out of the set of facts and law creating the initial legal ruling. The structure of this precedent methodology used in our legal system which is premised on the subsequent ruling looking at fact variations that were not and often could not be considered at the time of the first ruling, creates modified rules governing all of the variations of facts – all of the marbles in the bowl – with fewer mistakes from application of the modified rule or its exclusion. It is a honing of the initial court's ruling to make it more accurately apply to the potentially vast variations of facts

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that may arise in application of legal principles to fact patterns. From one vantage point, this is decision by trial and error with the hope that the degree of error is not too great and that the time to correct the errors inherent in our system of legal decision making is not too long.

Regrettably, errors are sometimes made of great magnitude by courts from the Supreme Court of the United States and the comparable courts of our States to the trial courts of our federal and state systems. One need only look at decisions of the Supreme Court in the antitrust context made decades ago and overruled in more modern times to decisions of lower courts that were incorrect and took an extended time to alter or correct.

This is why other disciplines use mathematics and other quantitative methods. What they do is convert facts and applicable principles to mathematical representations. Once converted, methods of varying one to some or all of the various permutations of applicable facts and principles may be utilized to arrive at a rule or principle that more accurately governs all permutations. More concisely, mathematics is used to overcome the limitations of verbal analysis and to derive a "rule" that may be accurately applied to far more of the marbles in the bowl. It is the reverse of what lawyers and judges do using words!

Once one knows and understands why what lawyers and judges do using verbal analysis is innately inaccurate in many instances, one may apprehend why allowing what could be thousands and thousands of so-called small business cases to utilize Chapter 12, compared to the much smaller number of family farmers and fishermen, will undoubtedly create problems for family farmer and fishermen cases. First, the possibility of a significant increase in number of cases in Chapter 12 heightens the likelihood of a ruling made in a non-farm and non-fisherman case being applied to family farmer and fishermen cases which does not work for a farm or fishery. Second, the facts involving farming and fishing will tend to be different from many small business cases. This means that to get a correct result in a family farm or fishing case, one may have to resort to distinguishing a decision made first in a non-farm or non-fisherman small business case. This distinguishing may take years or decades before it successfully occurs. In the meantime, family farmers and fishermen will be subject to a governing rule of law that may be inaccurate or, worse, downright wrong when applied to them.

It is because of the heightened potential for incorrect or inaccurate results inherent in our legal system's methods of deciding cases and issues should Chapter 12 be expanded that I suggest that any change in small business provisions not be placed in Chapter 12. Rather, it should be elsewhere such as where it currently is in Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101 et seq. It is not a question of whether such a problem would occur. Rather, it is only when and in what context it would happen.

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Question 2. In your opinion, does it make more sense to amend Chapter 11 to accommodate small business bankruptcy concerns? What about creating a new small business bankruptcy chapter in the Bankruptcy Code?

Response to Question 2. If Chapter 12 were expanded to encompass small business cases, it would result in business bankruptcy reorganizations being able to be placed under four (4) portions of the Bankruptcy Code set forth in three (3) chapters of the statute: Chapter 11 for non-small business bankruptcies, Chapter 11 for small business bankruptcies with just under $2,200,000.00 in aggregate debt, Chapter 13 for certain individuals with noncontingent, liquidated, secured debt of approximately $1,000,000.00 and noncontingent, liquidated, unsecured debt of just under approximately $340,000.00, and the National Bankruptcy Conference's proposed Chapter 12 for those entities with aggregate debt of $10,000,000.00 or less. Depending on any final definition of what is a small business, this also means that some small businesses will have three (3) options for a bankruptcy filing: Chapter 11, Chapter 12, and Chapter 13. This is the category for certain individuals in business. For legal entities which come within the definition of a small business, it would provide potentially two (2) venues to reorganize: Chapter 11 and Chapter 12.

Despite the fact that some family farmers and fishermen contemplating bankruptcy have three (3) options for reorganization, Chapters 11, 12, & 13, it only further complicates an already technical statute to allow Chapter 12 to be used by small businesses. I say this not just based on my comments in response to Question 1 along with what is set forth above in response to this question, but also from the viewpoint that altering the existing provisions of Chapter 11 allows the small business provisions to remain where they are currently are located. This is a little more on why I believe that amending Chapter 11 is a better approach.

As for creating a new small business bankruptcy chapter in the Bankruptcy Code, I generally believe this is not the better approach. I say "generally" because it is subject to a couple of factors. One is the definition of a small business. It may be that the definition of a small business could be set so that it represents a smaller fraction of all businesses consisting of those with few employees, low levels of debt and revenues, and limited complexities, if any at all. The other is whether Congress determines that it wants to change the fundamental basis of reorganization as it currently exists in Chapter 11, one designed to be consensual when possible, to one where creditors have far less input into the reorganization of a debtor and where the debtor has control of the reorganization plan subject only to compliance with what bankruptcy law allows as is the case under Chapter 12. Should the definition be of the nature set forth in this paragraph, and Congress determine that a non-consensual, debtor-controlled plan of reorganization is what is appropriate, then a separate chapter may be the better approach.

Question 3. In your written statement, you take issue with the lack of quality data from bankruptcy cases that could be used to accurately understand the utility of Chapter 11 for small businesses. Could you describe the kinds of data that you believe should be collected?

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Response to Question 3. Although made in the context of proposed changes to the Bankruptcy Code for small businesses, my comments regarding the failure to capture and make available data extends to all aspects of bankruptcies filed under our laws. I will limit my suggestions to small businesses, but many are equally applicable to all debtors under all chapters of the Bankruptcy Code.

Some of what is needed is being better able to know the debt structure along with the revenues of small businesses. Part of improving this data is to ensure that debtors accurately complete the currently required forms. As my written testimony of March 17th and supplemental testimony of March 23rd indicate, thousands of those filing business bankruptcy cases either leave blank or only partially complete Official Forms 1 and 6. With many completed forms, the responses are inconsistent for the identical information required to be disclosed in both.

Additional information about the businesses in a readily accessible format would also enhance what it is that Congress wants to know and how to make changes to accomplish its goals. For instance, adding categories for revenues by fiscal or calendar year and the number of employees of a business in the initial filing documents would allow one to more easily determine whether a business is truly a small one or not.

Other information would help our understanding of what works in reorganizations under our bankruptcy laws. For instance, keeping track of the number of cases that proposed a plan of reorganization and how long it took to propose a plan coupled with information about the size of a particular debtor and other financial data such as cash flow may enable one to learn if one or more factors contribute to a longer or shorter time before a plan of reorganization is proposed. Similar data on the rate of confirmation of plans and the size and type of business involved could give a better understanding of how these factors interplay with others in the reorganization process, including achieving confirmation of a plan.

Keeping track of what happens to a reorganized debtor following confirmation of a plan is yet another example of needed facts. What this would permit is one to know the success – or lack thereof – over time for reorganized entities. Today, the success of our bankruptcy laws for truly reorganized debtors is guess work, at best, due to the absence of knowing what has happened over time following confirmation of a plan of reorganization.

Other areas of interest should include data that may be used to analyze what are the causes of filing bankruptcy. Having better data in this area would lessen attributing bankruptcies to one factor or another without the needed information and analysis and contriving ideas of cause and effect based on what is the desired outcome. Stated differently, it would cut down those who say something is caused by a factor(s) when the reality is that what is being said is not accurate.

Unfortunately, the list of categories of what we should know is rather long and beyond a

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more detailed discussion in my responses to Senator Grassley's questions.

What needs to occur is a determination by Congress, along with other professionals beyond lawyers and judges, of what is important to know on a factual basis and what is helpful to know for developing better functioning bankruptcy laws. Why this must occur is that one of the ways to improve what happens in bankruptcy is to know how it really works, or does not work, and adopt changes based on quantitatively verifiable data, not speculation and guess. Improvement in how the bankruptcy process functions based on such data has the added benefit of, among other things, reducing the risks of bankruptcy to creditors along with a better allocation of scarce resources to better uses for our economy. Simultaneously, it would assist debtors to better understand the whens and hows of bankruptcy so a better outcome may be achieved. In other words, it permits us to better redesign bankruptcy laws to potentially save jobs of some or reallocate resources to other enterprises with greater job creation potential than that of a business that is declining. A further discussion of this potential is set forth in response to question 9.

Question 4. In your written statement, you discuss the fact that the National Bankruptcy Conference relies on flawed studies to make the case for its proposed new bankruptcy law revisions. In you opinion, what is the single biggest flaw in these studies?

Response to Question 4. In my written statement, I did not indicate that any particular study relied on by the National Bankruptcy Conference was flawed because I did not have to do so. Although I believe at least one to be fundamentally flawed for purposes of actually knowing, as opposed to speculating, what are some of the problems with bankruptcy cases, my point was that the essential studies relied on by the National Bankruptcy Conference may not properly be utilized for the purposes for which they have been cited.

This is because the critical ones do not purport to be based on a random sample of data from across the United States regarding small business bankruptcies or business bankruptcies, big, medium, or small. Instead, one is based on the authors' admittedly non-random sample of data from only a minority of bankruptcy jurisdictions using only business bankruptcy cases of certain types by size of selected dollar categories such as debt and assets. The authors of this study admit that their conclusions are not necessarily correct, but, for want of better data, are their best interpretation of what they believe to be the state of affairs for a time period from over a decade ago. The single biggest flaw in this study is that it is not much better than intuition for what was and is the real state of affairs and its causes. This is not the kind and quality of information upon which Congress should base legislation.

The other purports to be a complete sample for a particular time period of one division of one bankruptcy district of the United States. It does not obtain data from a random sampling of all portions of the United States and of all categories of businesses. The author also sets forth that what he has determined is not expandable to a general discussion of bankruptcies across the

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United States. Furthermore and should its findings for the Northern District of Illinois, Eastern Division hold true for the United States as a whole, it indicates the incorrect nature of three of the four so-called fundamental flaws of the current Chapter 11 process upon which the National Bankruptcy Conference premised its position paper for small business bankruptcies.

The central point of this portion of my written statement regarding the lack of random sampling and quantitatively verifiable data was and is that none of the critical studies upon which the National Bankruptcy Conference has relied may properly be used to support its assertions about small business bankruptcies. This arises from the authors' explicit limitations on such extrapolations. This means that the legislative changes, too, should not be premised on such impermissible extensions of data.

Question 5. You indicate that 67% of all Chapter 11 cases could qualify as small businesses. Do you believe that the National Bankruptcy Conference's proposed definition of small business is too broad?

Response to Question 5. Yes. Because of the failure of Chapter 11 debtors to entirely fill out Official Form 1 and Official Form 6, the data regarding assets and liabilities for all business bankruptcy cases filed in 2009 varies between these forms. Using the $10,000,000.00 or less in aggregate debt as the cut off for small business entities, Official Form 1 responses for 2009 indicate that about 67% of all cases filed in 2009 could come within the definition of a small business entity. From Official Form 6, the responses indicate that potentially 87% of cases filed in 2009 would be within the National Bankruptcy Conference's proposed definition of a small business entity. See pp. 8-9, 17-18 of March 17, 2010 Written Testimony of Hon. Thomas B. Bennett. In my supplemental written testimony, the 2009 data for small business filings under the existing definition of a small business – those with aggregate debt of approximately $2,200,000.00 – is in the range of 21.15% to 23.47%. Had the NBC's definition been in place for calendar year 2009, the percentage of small business filings would go from just under one quarter to somewhere between approximately two-thirds to almost 90% of all Chapter 11 cases filed. Included as a small business entity using the NBC's definition would have been three (3) with assets over a billion dollars, seven (7) with assets exceeding five hundred million dollars up to a billion dollars, twenty-one (21) with assets of over one hundred million dollars up to five hundred million dollars, thirty-four (34) with assets greater than fifty million dollars up to one hundred million dollars, and two hundred sixty-three (263) with assets over ten million dollars up to fifty million dollars. Under its proposed definition, some businesses that are not small are classified as small business entities.

Question 6. Do you believe that the National Bankruptcy Conference's proposed definition of small business could be gamed or abused?

Response to Question 6. Unless there is an intentional misrepresentation of the debt levels, the aggregate amount of qualifying debt under the NBC's suggested definition is ascertainable. As a

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result, I do not see that it is capable of being gamed or abused. To the extent that debt is accurately disclosed, is at or below the $10,000,000.00 sum, and includes entities that are not really small businesses, for example those with thousands of employees or assets in the multiple hundreds of millions of dollars or more, using the NBC's proposed Chapter 12 instead of Chapter 11 would be a permissible option for such businesses. I do not view this as gaming or abusing a system should it be so designed. However and for reasons already delineated, I do not believe the proposed definition should be that which the NBC proffers.

Question 7. How would you define small business for a small business bankruptcy chapter?

Response to Question 7. As I set forth in my supplemental written testimony of March 23, 2010, I do not believe that aggregate debt, by itself, is susceptible of defining a small business entity. Rather, I believe another factor or factors should be utilized which include one or more of total assets, total revenues, and number of employees. Each is relatively easy to determine and verify. Total revenues and number of employees are better measures for some businesses such as those with relatively little in assets and those with insignificant debt that still have substantial operations which may be more accurately indicated by revenues or employees. An example is a service business which will frequently have relatively little in assets, but significant revenues and potentially a large employee base. Additionally, I would create a mechanism by which a business entity could be excluded from the small business category because of complexities that are not usually associated with debtors having debt, assets, revenues, or employees below a set number or within the other factor(s) Congress may select to define a small business entity.

Question 8. The hearing witnesses have discussed problems that small businesses have in filing for bankruptcy under Chapter 11. What provisions in Chapter 11 do not pose problems for small businesses in bankruptcy?

Response to Question 8. This question is somewhat difficult to answer due to its broad scope and whatone sees as a "problem." In any given Chapter 11 case, a debtor may face a problem caused by the requirements of certain sections of this chapter. That one debtor or a few may have a "problem" with compliance with a given section of Chapter 11 does not mean that for most it is a problem. So, I limit my response to those provisions that generally do not present difficulties regarding compliance or enforcement.

There are four (4) subchapters to Chapter 11. Subchapter IV deals with railroad reorganization and is excluded from consideration as part of this response. The remaining subchapters are Subchapter I involving officers and administration of a debtor's estate, Subchapter II delineating the who, what, how, and when of a plan of reorganization, and Subchapter III for postconfirmation matters such as the effect of confirmation, plan implementation, distributions under a plan, revocation of confirmation, and two sections dealing with specialized matters involving taxation and securities laws.

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For those provisions of Subchapter III for postconfirmation matters, which are set forth in 11 U.S.C. §§ 1141-1146, these do not generally pose problems for small businesses. As for Subchapter I, officers and administration of the estate, these sections with the exception of 11 U.S.C. §§ 1113-14, generally do not cause problems for small business debtors other than the fact that having a creditors' or equity security holders' committee or an examiner will tend to increase the professional costs of a case. As for the rejection of collective bargaining agreements and payment of insurance benefits to retired employees set forth in 11 U.S.C. §§ 1113-14, these provisions in some small business cases make reorganization more difficult, if not impossible. The same is true of these two sections for medium and large Chapter 11 cases.

The bulk of the problems encountered by small business Chapter 11 cases arise in what is governed by Subchapter II which deals with plans of reorganization. Section 1121 on who may file a plan and its timing is not a problem unless one views the time periods too short or too long and the ability of a creditor to propose a plan as a problem. Similarly, the classification of claims or interests in § 1122 does not generally create difficulties for small business entities. The same is true for § 1128 dealing with the confirmation hearing's notice and who may appear and object to confirmation and § 1124 on delineating what is an impaired claim or interest.

The bulk, if not almost all, of the "problems" of Chapter 11 for small business entities arise from what is required to be in a plan under § 1123, the postpetition disclosure and solicitation of acceptance of a plan under § 1125, § 1126's acceptance of a plan provisions, modification of a plan under § 1127, and plan confirmation necessities under § 1129. It is not the entirety of these sections which cause problems, but only portions of each. When viewed from the context of all of the relevant provisions for small business entities, it is only parts of a few of them that present any significant "problem."

Question 9. Could you elaborate on how you think that broadening Chapter 12 to include non-farm businesses could increase borrowing costs for small business borrowers?

Response to Question 9. On pages 9 through 11 of my written testimony of March 17, 2010, I set forth a discussion of what NBC's proposed changes for small business bankruptcy cases could shift the majority, if not substantially all, cases now reorganizing under Chapter 11 to Chapter 12's regime. To avoid repetition, I incorporate the prior testimony as part of this response to Senator Grassley's question and will summarize and expand this earlier testimony.

In its quintessence, the NBC's suggested changes for small business entities alters the fundamental dynamics of Chapter 11's preferred consensual form of reorganization where creditors and other interest holders have input in a debtor's ongoing operations, plan design and its implementation to one in Chapter 12 where there is no real input and only the ability to object to what a debtor does and would like to do in a plan. It also alters certain critical treatments for

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creditors regarding adequate protection of a creditor's secured status, the use, sale, and lease of a creditor's collateral or interest holder's interest in property, conversion or dismissal of a case, treatment of rejection of collective bargaining agreements, and payment of insurance benefits for retired employees, among other provisions. Each of these changes imposes a burden on creditors and certain parties in interest. Also, it eliminates the absolute priority rule of 11 U.S.C. § 1129 for debtors that are not individuals. Its elimination in many cases will result in the risk of failure and of additional losses to be borne solely by creditors, not by the owners of a reorganized entity. To put it differently, alterations of each of these increases the risks associated with bankruptcy for creditors of a small business entity should the NBC's proposed changes be enacted without modification.

In a similar fashion, Chapter 12's less detail and loosened requirements of debtors, when compared to the stricter and heightened mandates of Chapter 11, give creditors less ability to approximate the costs of failure by a small business entity. Lowering some of the of what is now required of small businesses under Chapter 1 as is done under the NBC's proposal also increases the risks associated with providing credit to businesses.

For analytical purposes, changes in the risk, as with changes in other factors bearing on the supply of credit excluding its price, are classified by economists as non-price changes. To assess the impact of a change in a non-price factor on the supply of credit, one needs to hold constant all other variables that influence its supply. By doing this, it isolates the effect of a change in the factor being considered, here increased risk caused by a change in bankruptcy laws, from other factors that may simultaneously change for unrelated reasons. More simply put, it lets one see the impact of the factor being viewed without its effect being covered up or masked by what others may cause to happen. For example, the increase or decrease in the supply of money by the Federal Reserve may be of such a magnitude when compared to a change in risk associated with bankruptcies that one is unable to see what the change in risk in bankruptcies did to the cost of credit without isolating the effects of other variable such as changes in the supply of money by a central bank.

Before going forward with this discussion, please note that my earlier testimony was in terms of increasing the cost of credit over what it otherwise would have been and decreasing the supply of credit from what it otherwise would have been as a result of the increase in risks associated with the NBC's offered changes to bankruptcy reorganizations. In other words, it was a discussion of what could be expected to occur if all other factors influencing the supply and demand for credit were held constant or isolated from the effects of an alteration in the bankruptcy laws. Also, it was not that interest rates would necessarily go up or down or that the aggregate supply of credit would increase or decrease. Added to this is that the discussion was in the context of the market for credit generally and not with reference to what some might call the submarket for credit for small businesses, if such a submarket exists. This means that the discussion was on the impact such bankruptcy law changes would have on the cost and supply of credit for all who lend and borrow, not just small businesses.

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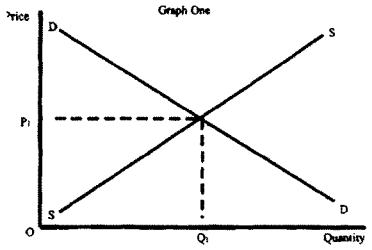
Having set forth an outline of what I previously testified to, use of graphs will help one understand what one would expect to occur from an increase in risk to the suppliers of credit from the NBC's suggestions for small business bankruptcies. Before any changes, one would expect that those supplying credit and those demanding credit would each be willing to supply credit in varying amounts at different prices, or interest rates, and that borrowers would be willing to purchase credit – borrow – at varying amounts at different prices. The mathematics of both the amounts offered as the supply and the demand for credit may be seen by a graph such as the one below captioned Graph One because a graph is merely a picture of the mathematics.



In Graph One, the line SS is the market supply of credit at various prices and the line DD is the market demand for credit at various prices. The downward slope of DD represents what one would normally expect to occur which is that the higher the price of credit, its interest rate, a lower amount of aggregate borrowing would occur and at lower interest rates more borrowing would take place. Similarly, the upward slope of the supply curve for credit, SS, reflects that at lower interest rates lenders would in the aggregate offer less credit and as the price for credit increases they would be willing to offer more credit. The intersection of these lines at the price P1 and quantity Q1 is where the amount of credit supplied equals the amount of credit demanded. It is sometimes referred to as the equilibrium point. At various times, one would expect the supply of and for credit to reach an equilibrium. Here it is at P1 and Q1.

When one changes the risks of lending, one would expect to find that creditors are unwilling to lend the same amounts at each given price as they were before a change in the risks of lending. If there is an increase in risk, a lender would normally not be willing to lend the same amount of monies unless the price received goes up. This would be true for each amount of credit and for each lender. Thus, an increase in the risk associated with a change in the bankruptcy laws will cause the original supply of credit represented by SS to shift to the left and upward to the line represented by S1S1. This is shown in Graph Two. What S1S1 shows is that for each amount of credit offered by all lenders a higher price – the interest rate – is associated. Joined with this and without other factors changing, the new equilibrium point where the demand for credit equals its

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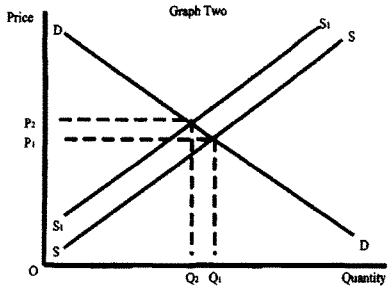
supply will be at a price P2 which is higher than it was before the risk increasing change in bankruptcy laws and at a demand for credit at the quantity Q2 which is below the equilibrium between supply and demand before the risk increasing change in bankruptcy laws.



In summary and when other factors affecting the supply and demand for credit are held constant, the cost of credit will increase over what it otherwise would have been and its supply will decrease from what it otherwise would have been at each price point. What this means is that if interest rates increase overall, they will increase more than they would have had the increase risk of changes to bankruptcy laws not occurred. Conversely, if interest rates decrease overall, they will decrease less than they would have otherwise but for the increase in risk caused by the proposed changes to the bankruptcy laws by the NBC. This means that the cost of credit will be higher than it otherwise would have been for all borrowers, including small businesses, and the supply of credit by lenders will be less than it would have been. These are the implications from increasing risk to lenders from changes in the bankruptcy laws.

There is a potential countervailing factor that is not taken into account by the NBC's proposal or set forth in its discussion. If one redesigns the bankruptcy laws governing small businesses in a way that decreases the risks associated with bankruptcies, the supply of credit would be expected to shift to the right and downward representing lenders willingness to loan greater amounts at lower prices. This is shown on Graph Three by the supply curve marked S2S2. At each price, lenders are willing to lend more in the aggregate than what was the case before a decrease in risks caused by a change in bankruptcy laws. It also would create a new equilibrium at a quantity of credit Q3 – more credit supplied at a given price – which is greater than it was before the law change at Q1 and a decrease in the price of credit to P3 from what it was at P1 before the alteration of bankruptcy laws. Increasing credit availability at the same or lower price than it would otherwise have been is achieved by a change or changes in bankruptcy laws creating

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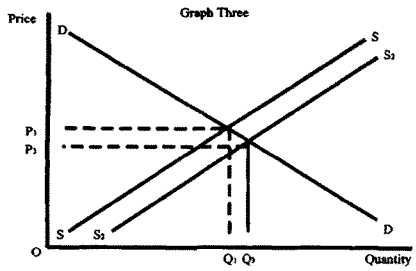
a decrease in risks to creditors that more than offsets the increase in risks associated with the changes proposed by the NBC. Unfortunately, it does not appear that this is what will occur under the proposed amendments to Chapter 12. This is because there is no question that certain risks increase for lenders under the proposal. However, there is no such certainty that risk decreasing factors will occur, if any would exist at all. To get to any goal that does not lower creditors' willingness to laon, what should be done if a change in bankruptcy laws is to be made is to ensure that any increase in risk to lenders associated with such a change is fully offset by other alterations of the law that will decrease lenders' risks.



Question 10. In you opinion, are there any provisions in Chapter12 that could be helpful to small businesses in bankruptcy? Are there other improvements that Congress should consider for small businesses in bankruptcy?

Response to Question 10. Whether any provisions of Chapter 12 could be helpful to small businesses depends on whether Congress determines that the currently applicable provisions should be fundamentally altered to eliminate various requirements in Chapter 11 such as the absolute priority rule and the preferred consensual concept on which Chapter 11 reorganizations are premised. Without making such an initial determination and because many of the provisions of Chapter 12 mimic in part what is in Chapter 11, I am not able to respond to what parts of Chapter 12 which differ in important aspects would be helpful for small businesses. Having made this disclaimer, there is one feature of Chapter 12 that in concept has merit for purposes of designing modifications for small business entities attempting to reorganize via a bankruptcy filing. It is the simplification of the plan and plan confirmation process for small businesses. This is different from the idea that the Chapter 12 plan and plan process is the vehicle that should be adopted for small business bankruptcies. In my view, there needs to be a better plan development, disclosure and confirmation process for truly small businesses.

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From an historical viewpoint, much of what is the current Chapter 11 plan and plan process has come forward from what was developed under earlier bankruptcy statutes. By way of example and in particular, the involvement of the Securities and Exchange Commission was greater in many cases brought under the Bankruptcy Act of 1898 as amended. For this reason, some of what is boilerplate in current plans of reorganization has been carried forward from earlier days and is not really necessary, but for certain of the requirements of the Bankruptcy Code. Most of what is important to creditors and other parties in interest is a demonstration of workable business and financial plans with sufficient data to enable one to assess the likelihood that a plan will succeed. Unfortunately for small businesses, a lot of what is required is unrelated to the financial and business plans. What makes more sense is to have small businesses submit plans that principally address the business and financial issues, not side issues unrelated to financial and business planning. Doing this will simplify the plan process and its confirmation or not.

Joined with this is the need for better information from debtors regarding both business and financial planning that many small businesses do not have the ability to provide or they are unable to afford the necessary expertise. A means should be implemented to assist small business entities. Various options should be considered that would assist small businesses in this regard. One is to fund hiring of such professionals. Another is to require expertise to be made available by one or more government agencies which could include, but is certainly not limited to, the Bankruptcy Administrator Program and the U. S. Trustee Program.

Question 11. Chapter 12 was a temporary chapter of the Bankruptcy Code for many years. Do you believe that changes to the Bankruptcy Code for small businesses should be temporary so that Congress can determine whether those changes do not have adverse consequences? What about a pilot program for small business bankruptcy?

Response to Question 11. With all due respect for Congress, I believe that a pilot program does not have merit **unless** the implementation of such a program for small business entities requires that data is accumulated in a meaningful manner that enables one to analyze in a verifiable method what has occurred during the pilot program. This requires planning from both a legal and nonlegal perspective for not just the types of changes needed to the bankruptcy laws, but also what sort of information will be needed to study what is desired to be known from such a program. Without such advanced planning and without appropriate data, what will most likely occur is speculation on the success or lack thereof of such a small business experiment. If the quality and quantity of data is required and obtained in a manner allowing valid and verifiable analysis of the impact of such a pilot program, it is better than adopting a wholesale alteration in the nature of reorganizations of businesses on the scale contemplated by the proposed modifications to Chapter 12.

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Question 12. I've heard concerns that requiring a dedicated trustee for small business bankruptcies would cause significant problems in the trustee workload and overwhelm the trustee system. Do you believe those concerns are valid?

Response to Question 12. It is a valid concern. Under the NBC's proposal for Chapter 12, there is no question that any significant shift of small business filings from Chapter 11 to Chapter 12 would dramatically increase the caseload for existing Chapter 12 standing trustees. Likewise, there would be a need for trustees that currently does not exist in areas without standing Chapter12 trustees. The NBC's proposal on page 18 reflects the potential for thousands of additional Chapter 12 cases being filed instead of the hundreds filed in recent years which would necessitate appointment of more trustees and the hiring of added staff for existing and newly appointed trustees. Depending on how long such a process takes, it is possible that the existing trustees could be inundated for a period and that trustees and staff would not be able to timely handle the increased caseload. However, and if hiring of trustees and staffing does not occur fast enough, this problem should lessen over time and ultimately end once sufficient trustees and staff are hired.

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Senator Grassley's Written Questions for Subcommittee Hearing "Could Bankruptcy Reform Help Preserve Small Business Jobs?"

Professor Mason

1. In your written statement, you refer to the "domino effect" of business failures, where the failure of one business negatively affects other businesses and individuals. Could you explain this idea in more detail? Do you think that liberalizing bankruptcy law increases or decreases the potential for such "domino effects"?

The "domino effect" is really just another name for systemic risk. All businesses exist in the context of an economic system, where both profit and loss are transmitted through the system to affect economic growth or decline in the aggregate.

Bankruptcy, or more properly, restructuring in Chapter 11 or a variant, is really just a way to lay losses off to related business enterprises – particularly lenders and suppliers – in order to allow the business a second chance at profitability. If some businesses that could have muddled through some temporary difficulties find it more advantageous to enter Chapter 11 (or the new 12) and lay off losses to related lenders and suppliers, aggregate bankruptcy losses will increase.

Moreover, to the extent that those lenders and suppliers may find it similarly advantageous to lay losses off to their own lenders and suppliers via the new bankruptcy code, the effects of the initial bankruptcy may be transmitted widely through the business world. As a result, easing access to bankruptcy via relaxed standards for restructuring will increase both the number of bankruptcies and the aggregate business losses due to bankruptcies as profits are kept private while losses are spread throughout the business world.

2. In your opinion, would expanding Chapter 12 to cover non-farm businesses be more likely to exert upward or downward pressure on borrowing costs?

Continuing from above, if lenders absorb more losses from small business bankruptcies they will respond by increasing rates on small business loans. Furthermore, to the extent that policy changes cause confusion about absolute priority of claims for existing or new debt, lenders may retreat from providing credit altogether until that confusion is resolved.

It is important to note that none of those responses are per se undesirable. Rather, such responses merely reflect the economic realities of a change to bankruptcy law that shifts losses from one source to another. That does not mean that the change to bankruptcy law is undesirable – only that adjustment costs will be encountered in reaching a new equilibrium around the new law. As with health care legislation, some lenders and suppliers will be hurt more than others along the way. We will not be able to maintain the status quo

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through subsidies or loans to such businesses, for such a policy would illogically seek to entrench current results despite the changes to the law. Although we may be able to help affected businesses redirect their efforts through their own bankruptcy restructurings, to some extent, a messy transition will be unavoidable.

3. In your testimony, you discuss the commingling of personal and business assets in small business operations. In your view, in light of the difficulty in separating business assets and liabilities from personal assets and liabilities, isn't it impossible to bail out small businesses without also providing unfair benefits to those who have engaged in reckless overspending? Is there a problem of creating a moral hazard?

Moral hazard is a very real phenomenon. To the extent that we make it easier for businesses to restructure, however, we *expect* businesses to avail themselves of the tools provided. Hence, I would not consider it moral hazard for businesses to use the easier and more advantageous restructuring process that is envisioned. The reason is that the term moral hazard usually connotes some unintended consequence entertained by only one party to a contractual arrangement. Here, the makers of bankruptcy law fully intend for businesses to file more bankruptcies, so it will surely take no one by surprise if businesses actually do so.

To take the logic of being unwilling to extend bankruptcy to one who engages in "reckless overspending," however, is to carry the logic too far. While bankruptcy has historically provided relief to debtors, that relief is usually not attractive enough to, itself, cause strategic responses in otherwise healthy firms.

To the extent that bankruptcy was too advantageous for both lenders and borrowers in recent economic history, therefore, it can be argued that either the system was too lenient or individuals and firms were not operating at healthy income margins. My own economic view is that the latter was more important than the former. Nonetheless, no matter which is the case, making it easier to restructure small businesses in response will result in more reckless borrowing and lending.

4. Do you believe that the definition of small business in the National Bankruptcy Conference proposal is too broad?

The definition advanced by the NBC is "...a corporate or non-corporate person—other than a family farmer or family fisherman—who is engaged in a business or commercial activity and has total debts not exceeding $10 million, provided at least fifty percent of the debt arises from the person's business or commercial activities."

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That is a pretty broad definition. Nonetheless, the cutoff is really more a pure policy decision than an economic definition, since there is little quantitative or theoretical evidence on which to base the number. Moreover, business – much less small business – assets are difficult to define, so that we have little economic data with which to judge whether there exists some kind of operational threshold that requires more assistance below than above. Hence, I have no firm opinion on the specific cutoff, and would find it difficult to argue in favor of, say, a $5 million cutoff rather than a $10 million on the basis of any economic fundamentals.

5. Do you believe that the National Bankruptcy Conference's proposed definition of small business could be gamed or abused?

The more difficult aspect of the definition is the seeming simplicity. It is well-known that the small business definition used by the Small Business Administration, for instance, gamed through its static definition. Many businesses grow through the SBA definition, yet are still eligible for SBA financing as a result of their grandfathered status. In particular, you probably don't want a large business to achieve small-business status through a pattern of prolonged distress that stops only when it renders the firm eligible for the new bankruptcy Chapter. Perhaps such developments could be stemmed by using a moving average business size criterion and using a specific business revenue cutoff (as reported on IRS filings) rather than assets (especially since assets differ across industries).

6. How would you define small business for a small business bankruptcy chapter?

As stated above, I would use something like a five-year a moving average of revenues reported to the IRS.

7. The hearing witnesses have discussed problems that small businesses have in filing for bankruptcy under Chapter 11. What provisions in Chapter 11 do not pose problems for small businesses in bankruptcy?

As noted below, according to the Morison study the perceived impediments to small business utilization of Chapter 11 are specious.

> "Chapter 11 process appears to sort effectively between businesses that are viable and those that are not. Biases commonly ascribed to the system are largely absent from the data. Neither creditors nor debtors (managers or equity holders) dominate the bankruptcy process. Instead, bankruptcy judges play a major role in filtering failing businesses from viable ones, and they appear to be able to do this job well. … Finally ... [and] [t]aken together, these findings suggest that the small-business Chapter 11 process has significantly lower cost and displays significantly less bias than is commonly thought."

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Nonetheless, it must be acknowledged that small businesses often operate with thinner cash cushions than larger businesses, so that speedy confirmation can be advantageous.

8. Do you know to what extent the tightness of the credit markets has been responsible for small business liquidation, as opposed to insolvency or bankruptcy laws?

This is a difficult question to untangle. Any economist that says they know the answer should be treated with suspicion. We do know that lenders have been economizing on capital and reserves in the last twenty-four months and have been reluctant to lend, generally. We also know that the situation in much of the commercial lending world is stabilizing, albeit at high loss levels. And we also know that bankers with capital are becoming hungrier for good commercial loan clients that have been denied capital.

We also, however, know that consumer sentiment remains suppressed. That means that many consumer-oriented businesses are faltering. Businesses like health clubs, high-end coffee shops, and hobby shops of all sorts – ranging from motorcycle and ATV dealers to ceramics painting – are struggling. If consumers finally realize that debt only replaces future income, so that borrowing in a world of stagnant income growth is ill-advised, many of those businesses will not and cannot survive. Without real economic growth and real income growth, which both have been absent since the early 2000s, there will be fewer business revenues to go around. In my view, then, current business environment may reflect a long-term trend toward different consumption patterns, so that to attempt to stanch the shift would be counterproductive.

9. In your opinion, are there any provisions in Chapter 12 that could be helpful to small businesses in bankruptcy? Are there other improvements that Congress should consider for small businesses in bankruptcy?

The speed of establishing the viability of the firm is one of the crown jewels of Chapter 12 that should be emulated for all small businesses.

Chapter 12 failed to recognize, however, that short-term lenders hold the power of renewal – that is they can refuse to lend next period if forced to take losses this period – that gives them the ability to jump the absolute priority creditor queue. As a result, Chapter 12 put losses to long-term secured lenders before short-term unsecured lenders, unnecessarily and unexpectedly.

10. Do you believe that the availability of cram down for small businesses in bankruptcy will increase borrowing costs for small businesses? Do you believe that the availability of cram down will entice individuals to game or abuse the bankruptcy rules?

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Cram down inevitably raises borrowing costs. Still, cram down on standard depreciating assets merely writes off the liquidation cost of the collateral in the manner of a short sale. Hence, cram down on a depreciating asset entails no risk that the borrower will strategically gain from the cram down later on.

Cram down on assets that can appreciate, however, sets the stage for strategic bargaining and moral hazard, raising borrowing costs even further.

11. Chapter 12 was a temporary chapter of the Bankruptcy Code for many years. Do you believe that changes to the Bankruptcy Code for small businesses should be temporary so that Congress can determine whether those changes do not have adverse consequences? What about a pilot program for small business bankruptcy?

While a pilot program may have merits, a "temporary" status only increases uncertainty above that normally associated with any policy change. Some lenders may be tempted to sit out the change and hope it goes away. Few jump in to learn the ropes of complex new laws if they may be substantially changed a short time later. In my opinion, it makes sense to enact a firm body of law with a few discretionary elements, i.e., the business size cutoff and other quantititative parameters.

Senator Sessions' Written Questions for Subcommittee Hearing "Could Bankruptcy Reform Help Preserve Small Business Jobs?"

1. Professor Mason, the International Council of Shopping Centers, Inc. ("ICSC") submitted a statement that I offered for the record. The statement says, in part, the following:

> "ICSC believes enactment of the NBC recommendations would cause serious disruptions to the commercial real estate market, a market that is already suffering as a result of the recession and the credit crunch. According to some estimates, local and regional banks hold $1.4 trillion in commercial real estate loans that will come due in the next three years. In addition, over 66% of shopping center lenders are banks. In 2010, fully 28% of commercial real estate loans to shopping centers will come due and there is a significant need for refinancing. Any proposal that would make banks more reluctant to lend to shopping centers would adversely affect ICSC members and the American economy.
>
> ICSC believes that any chance of a thaw in the frozen credit markets could be reversed if the NBC Chapter 12 proposal is adopted. This proposal could cause a downward spiral in which small business tenants of shopping centers face greater difficulty obtaining credit which, in turn, makes banks less willing to extend

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credit to shopping center owners. Such a cycle could do serious harm to the possibility of an economic recovery."

a. Do you believe that ICSC is correct that substantial problems might develop in the small businesses credit market if the NBC proposal is enacted?

Yes. The ICSC's business segment, shopping centers and malls, is at the epicenter of the economic dynamic described above. I reiterate, therefore, we know that consumer sentiment remains suppressed. That means that many consumer-oriented businesses are faltering. Businesses like health clubs, coffee shops, and hobby shops of all sorts – ranging from motorcycle and ATV dealers to ceramics painting – are struggling. Many of those businesses are located in shopping centers throughout the country.

If consumers finally realize that debt only replaces future income, so that borrowing in a world of stagnant income growth is ill-advised, many of those businesses will not and cannot survive. Without real economic growth and real income growth, which both have been absent since the early 2000s, there will be fewer business revenues to go around. If owners of shopping centers bear the preponderance of losses for propping such businesses up while they continue to falter, those owners can be expected to falter, as well, dumping more commercial real estate on markets, suppressing prices further, and drawing the recession out longer than would otherwise be the case.

b. If the NBC proposal is enacted, do you think its effect on the small business credit market will have any effect on the number of new businesses started after the proposal's enactment?

While the proposal may not have an effect on the *number* of new small businesses created, it will have an effect on their *growth*. Without as much credit or with more expensive credit, businesses will grow more slowly. Businesses will need to achieve greater profitability before borrowing for further investment, meaning slower growth, overall.

c. Do you think enactment of the NBC proposal might have an effect on the number of new jobs created in the small business sector?

As above, slower business growth means slower job growth. There is nothing in this bill, nor can there be, that will annihilate the limits of economic principals. Making small business bankruptcy more widely available will impose costs upon society. The policy, therefore, will have to be promoted on the basis of the Pareto optimality (absolute comparative superiority) of the new equilibrium, where small business bankruptcy is more widely available.

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New small business bankruptcy rules may, in fact, be worthwhile. But switching will inevitably impose costs on existing businesses. Hence, the only decision variable is the timing. As a result, I think it is ill-advised to make the switch during or immediately after a sharp recession, when businesses need contracting certainty in order to grow.

2. ICSC states further that:

> "the evidence makes clear … [that] Chapter 12 ... has increased costs to society by encouraging inefficient farmers who would otherwise liquidate to remain in business and allowing efficient farmers who could otherwise continue to farm to charge off part of their debts. Bankruptcy costs include legal fees and efficiency costs from continuing to use labor and capital in otherwise inefficient enterprises. There is every reason to believe these negative economic effects could be magnified should Chapter 12 be expanded beyond its original, narrowly-focused purpose."

Do you believe that Chapter 12 is partly responsible for the conditions causing family farmers to have difficulty obtaining affordable long-term credit?

Indeed, that is the economic point of lowering the bar on reorganization: to reduce the necessary efficacy level associated with a viable business enterprise. Such policy allows greater inefficiencies to exist in the marketplace and impedes capital redistribution to more efficient alternatives. It seems easy to advocate such policy when few efficient alternatives exist in the economy, as in a recession. But lenders and suppliers have their own ways of exerting forbearance in such times, as lenders are delaying foreclosures in today's business environment where there is a surfeit of purchasers for the collateral.

But reduced efficiency also means reduced revenues and profits. Lenders are naturally reluctant to allocate funds to less profitable business enterprises. To the extent, therefore, that Chapter 12 has reduced the efficiency of small farms, it has also hindered credit availability to those farmers it intended to help.

3. ICSC also believes that

> "One negative consequence of broadening Chapter 12 to so many new types of business debtors would be the abrogation of the absolute priority rule. This principle, a feature of American business bankruptcy laws since the 1890s, ensures that lenders do not lose their legal priority because a borrower files for bankruptcy. Without the absolute priority rule, creditors of all sorts - including commercial landlords - face the very real prospect that borrowers could file for bankruptcy and pay themselves ahead of, and at the expense of, all creditors."

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a. What kind of impact it would have on the credit market if we allow debtors to obtain value from a business while avoiding complete payment of those who have lent equity to the business?

Every bond default or reorganization entails a struggle for value between equity holders and debt investors. Equity holders naturally want to extract the greatest haircut possible from debt investors. Debt investors naturally want to put the greatest hurt on equity holders. Moreover, the option to engage in negotiations is valuable as long as there remains substantial volatility to the underlying collateral and low interest rates that reduce the cost of waiting. Once collateral values stabilize and interest rates rise, equity and debt investors can usually come to rational conclusions about how to split the value. The need for clear information on enterprise values, therefore, is why so many bankruptcies take so much time to resolve.

In large Chapter 11 cases, members of creditor committees actively haggle for value. Moreover, large firms can borrow from many disparate sources. Hence, it is difficult for a single creditor to hold up the negotiations.

In small firms, however, a single creditor can easily hold up negotiations. Moreover, the single creditor that has the most to lose, the junior creditor, is often the most short-term. But small businesses – like large businesses – rely crucially on short-term junior lenders for working capital. The difference is that small businesses often have few alternatives for their short-term finance, so the short-term junior lender can extract significant value in negotiations on the threat that they will refuse to lend to the restructured firm next period. Without working capital, the small business is dead in the water and we are back to liquidation. As a result, long-term secured lenders get crammed down while short-tem unsecured lenders come out ahead.

Sadly, there is no way around this state of affairs. In large bankruptcies, a debtor-in-possession lender often provides short-term financing during and after the bankruptcy, but the amount of money lent in the DIP facility is often small relative to the size of the business enterprise. Hence, I think it makes sense to look to DIP usage and limitations as a guide to the extent to which abrogation of APR is feasible and desirable.

b. Do you think allowing the owners of bankrupt businesses to pay themselves ahead of their creditors will create incentives to fraud and abuse of the bankruptcy system?

Of course. But if you want to rehabilitate a business, you have to have faith in the agency relationship that remains. Bankruptcy renegotiations are tough, particularly because the proposal on the table is to allow the same managers that got the business into trouble the chance to bring it back to life. Again, this is particularly a small business problem. In large

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bankruptcies, managers are routinely replaced as a condition of restructuring. When the sole manager is the owner, such replacement is not possible. Hence, the natural limitations of small business reorganization are apparent.

4. Edward R. Morrison concludes in Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies that

> "Chapter 11 process appears to sort effectively between businesses that are viable and those that are not. Biases commonly ascribed to the system are largely absent from the data. Neither creditors nor debtors (managers or equity holders) dominate the bankruptcy process. Instead, bankruptcy judges play a major role in filtering failing businesses from viable ones, and they appear to be able to do this job well. ... Finally ... [and] [t]aken together, these findings suggest that the small-business Chapter 11 process has significantly lower cost and displays significantly less bias than is commonly thought."

The National Bankruptcy Conference relies on some data from the Morrison Study, but ignores its conclusion. Do you believe there is adequate data to properly access the impact of Chapter 11 or what data collection process would be necessary and beneficial to properly gauge the impact on small business reorganizations?

It is difficult to assess the dynamics of large, much less small business bankruptcies with available data. Nonetheless, Morrison's conclusions appear sound, including the conclusions of his "Serial Entrepreneurs" paper with Douglas Baird, which noted that "...among cases that were dismissed or converted, 70 percent of owner-managers went on to start new businesses or continued running other, non-bankrupt businesses. 85 percent of the owner-managers had founded a separate business in the past or went on to start another after the case was dismissed or converted." (Quoted from the NBC report)

Such results show that small business entrepreneurs are, well, entrepreneurial. As a result of those findings, we should not be looking at a small business bankruptcy as a one-off business failure, from which only a fixed pool of assets cash remains that will generate no additional cash flows. Rather, it may be more appropriate to look at even small business *liquidation* as a means of ending one business and beginning another – a form of cram-down reorganization. With entrepreneurs, all forms of bankruptcy are reorganizations, with the choice merely lying in the advantages of the means of filing.

Ultimately, we would like to be able to investigate the effectiveness of Chapter 11 for businesses of different sizes. Even Morrison could only accomplish that with a limited data

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set confined to bankruptcy filings during 1998 and 2006 in the Northern District of Illinois, excluding filings by non-corporate, non-profit, and real estate businesses. We would like to know a lot more, but systematic data is lacking. Hence, I strongly recommend that any changes to Chapter 11 be accompanied by requirements to begin systematic data collection on filings and outcomes, so that more comprehensive research can eventually better inform policy choices.

Thank you for the opportunity to testify and answer your questions.

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SUBMISSIONS FOR THE RECORD

March 24, 2010

The Honorable Sheldon Whitehouse
Chairman, Subcommittee on Administrative Oversight and the Courts
Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Jeff Sessions
Ranking Member, Subcommittee on Administrative Oversight and the Courts
Senate Committee on the Judiciary
152 Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for the Hearing Record, for the Hearing "Could Bankruptcy Reform Help Small Business Preserve Jobs?" Held March 17, 2010

Dear Chairman Whitehouse and Senator Sessions:

On behalf of the members of the American Bankers Association (ABA), Commercial Finance Association (CFA), Independent Community Bankers of America (ICBA), and The Financial Services Roundtable (FSR), we respectfully request that this joint statement and background paper be placed in the record for the Committee's March 17, 2010, hearing "Could Bankruptcy Reform Help Small Business and Preserve Jobs?"

The hearing focused on how the bankruptcy code might be improved to increase small business reorganizations. This is an important issue for our organizations because lending to small and medium-sized businesses is critically important to our member institutions, and the continued vitality of the small business sector is an indispensable element of future U.S. economic vitality and job growth.

As Congress investigates whether modifications of Chapter 11 could increase viable small business reorganizations, any such effort should proceed cautiously and build upon credible studies of small business bankruptcies and the effects of the reforms enacted in 2005 to the bankruptcy code by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). In fact, additional policy changes could have substantial repercussions, not just for those small business entities that seek bankruptcy protection, but for all small businesses that need working capital.

The attached white paper analyzes a legislative proposal made by the National Bankruptcy Conference (NBC) that would not be helpful. The NBC's recommendation to open Chapter 12 to all small businesses would constitute a significant departure from current law, as well as a risky experiment for the U.S. economy at the very time that Congress is working to increase the amount of credit available to small businesses so that they can help in generating new jobs. In fact, it may be possible to work with and perhaps modify existing Chapter 11 provisions, rather than unnecessarily expanding Chapter 12.

Our organizations stand ready to work with your Committee and Congress on efforts that may facilitate small business reorganizations. However, such efforts should be based upon empirically sound findings, must preserve essential creditor rights and an overall balance between debtors and creditors, and must fully consider their potential impact on the access to the credit markets by small businesses.

Thank you for considering our views.

American Bankers Association
Commercial Finance Association
Independent Community Bankers of America
The Financial Services Roundtable

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Background Paper: Chapter 12 of the Bankruptcy Code Is the Wrong Approach for Small Business Reorganizations

The importance of a vital small business sector to the U.S. economy cannot be overstated – according to the Small Business Administration[1]:

- Businesses having fewer than 500 employees represent 99.75 of all employer firms, employ just over half of all private sector employees, and have generated 64% of net new jobs over the past fifteen years.
- There are six million small businesses with employees.
- Small businesses have extremely high turnover rates and accompanying lender risk – with 627,000 new employer firms opening in 2008 and 595,600 closing that same year, and with only half of all new small businesses surviving more than five years.
- Commercial banks and other depository institutions are the largest suppliers of credit to small business, accounting for 65% of credit extensions.

Unfortunately, the proposal of the National Bankruptcy Conference (NBC) that received the most focus at the March 17th hearing held by the Senate Subcommittee on Administrative Oversight and the Courts, contained in its Report titled "A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize"[2], is a mistaken prescription for a misdiagnosed condition. The thrust of this report is a recommendation that the "family farmer" provisions of Chapter 12 of the Bankruptcy Code should be made available to all small businesses with aggregate debts of $10 million or less – and a principal rationale for that recommendation is to end what the NBC claims is "excessive secured creditor influence" in Chapter 11. The likely result of its adoption would be to increase the overall number of small business bankruptcies as lenders reduce the availability and increase the cost of small business credit in reaction to the substantially higher risk such loans would acquire in the Chapter 12 context. This is turn would have a devastating impact on small business sector growth and its critical job-generating role in the U.S. economy. This analysis is supported by the hearing testimony of Professor Mason of Louisiana State University, who declared that opening Chapter 12 to small businesses "will hurt both economic growth and small business owners."

This view is also supported by much of the testimony presented by Judge Thomas Bennett of the U.S. Bankruptcy Court for the Northern District of Alabama, who criticized the NBC's proposal as being far too broad as well as proposed without a basis in demonstrably accurate or verifiable data. Judge Bennett noted that the "basic facts" about small business bankruptcies postulated by the NBC were based on studies that either disclaimed broad extrapolation or that reached opposite conclusions – especially in regard to alleged "excessive secured creditor influence" in Chapter 11. Indeed, the NBC's analysis of the causes of the high failure rate of small business bankruptcies is clearly unsupported by adequate data and almost surely wrong, and is also directly contrary to the well-documented 1997 findings of the National Bankruptcy Review Commission (NBRC). After two years of

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[1] U.S. Small Business Administration FAQs: Advocacy Small Business Statistics and Research, available at http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24

[2] Report is available at http://www.nationalbankruptcyconference.org/position_statements.cfm .

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hearings and study the NBRC considered and rejected opening Chapter 12 to small businesses, yet the NBC report fails to mention that rejection much less address the policy rationale underlying it. The NBC report also fails to meaningfully discuss and adequately evaluate the impact of the expedited small business Chapter 11 provisions that were enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005 and which were directly based on NBRC recommendations.

NBC Report Is Refuted By NBRC Findings And Recommendations

The fundamental flaw of the NBC Report is its belief that the high failure rate for attempted small business reorganizations lies in the provisions of Chapter 11 rather in the circumstances and managerial skills of troubled small businesses.

The NBRC likewise found a high failure rate for small businesses entering Chapter 11, but concluded that the principal reason was not the Bankruptcy Code but the fact that most of these businesses had no reasonable and legitimate chance of surviving, and that prolonging their existence was contrary to the public interest[3]:

According to the many of the experienced individuals who appeared before the Working Group, the primary reason for the low Chapter 11 confirmation rate is that the great majority of Chapter 11 debtors lack any genuine prospect for reorganization, i.e. fundamentally, business viability is measured in terms of a consistent generation of cash revenue in excess of cash disbursed does not exist....It is essential to the legitimacy and continued public acceptance of Chapter 11 that its exceptional protections be limited to those cases in which the public derives a benefit therefrom. Creditors in an open economy have a legitimate interest in a prompt, fair determination of the viability of Chapter 11 debtors.

Likewise, the NBRC explicitly considered and rejected the concept of opening Chapter 12 (as well as Chapter 13's individual reorganization provisions) to small businesses, finding that the Chapter 11 structure was essential for the preservation and proper balancing of creditor rights:

Second, several thoughtful and experienced members of the bankruptcy community have urged the Commission to recommend extending Chapter 12 or 13 eligibility to business debtors. The Commission strongly believes that the requirements for creditor voting make Chapter 11 the most legitimate way to address creditors' rights. Therefore, it decline to recommend to the Commission that the law be changed to provide for the administration of small business debtors in Chapters 12 or 13.

The NBC report avoids any discussion of the substantial difference between its own opinion regarding the ultimate prospects for small business reorganization with the contrary, documented position of the NBRC, nor does it address the NBRC's explicit rejection of opening Chapter 12 to small businesses. But the NBC does make clear that it shares little of the NBRC's concerns for creditor rights – indeed, the NBC report claims that "excessive secured creditor influence" is a fundamental flaw of Chapter 11, declaring that "Chapter 11 gives secured creditors excessive influence over the process."

[3] The NBRC's small business recommendations can be found at http://govinfo.library.unt.edu/nbrc/report/15smallbu.html .

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What the NBC labels as "excessive influence" is more properly viewed as basic protection for those taking the risk of extending credit. One of creditors' greatest concerns about the NBC proposal is that it would essentially repeal the "absolute priority rule" for small business filings, an anti-fraud and abuse rule that prohibits the owners of bankrupt businesses from paying themselves ahead of and instead of their creditors, and that requires that secured creditors be paid in full before other creditor classes receive payment. The absolute priority rule has been in place for over 100 hundred years, ensuring integrity and preventing sham bankruptcies. This important public policy should not be abandoned, especially at a time when the economy is fragile and its future course uncertain.

And, as Judge Bennett discussed in his testimony, transferring small business bankruptcies to Chapter 12 also would:

- Replace a consensual approach with an adversarial one.
- Exclude creditors from having meaningful input into the reorganization plan.
- Provide a much less meaningful form of "adequate protection" to address secured creditor concerns about declines in the underlying value of their collateral.
- Allow expanded sales of secured creditor collateral.
- Restrict case conversion to Chapter 7 for reasons that do not exist in Chapter 11.

Further, while not direct creditor concerns, Judge Bennett also noted that allowing small business filings in Chapter 12 would remove the protective procedural features of Chapter 11 that govern rejection of collective bargaining agreements governing the wages and benefits of union workers; would do away with the "disinterested" standard designed to ensure fiduciary conduct by professionals assisting the debtor or trustee; and could lead to judicial decisions detrimental to the family farmers who are the intended beneficiaries of Chapter 12. These are all important collateral issues that should be carefully considered by Congress.

The NBC Report and proposal is also deficient for failing to adequately analyze the impact of the 2005 small business changes to Chapter 11, which were directly based on NBRC recommendations that achieved extremely strong bipartisan consensus among Commission members.

Based upon its analysis of small business bankruptcies, the NBRC made the following recommendations for balanced policy reform:

The Commission's Proposal addresses the need to move small business Chapter 11 cases at a pace appropriate for those cases by (i) establishing presumptive plan-filing and plan-confirmation deadlines specially tailored to fit small business cases; and (ii) directing bankruptcy judges to use modern case-management techniques in all small business cases to further reduce cost and delay.

The need for reform can perhaps best be underscored by the fact that nearly every jurist, academician, practitioner, and representative who appearing before the Commission has expressed the unmistakable sentiment that the system needs to be tailored in order to better serve the interests of justice and the special needs of small business debtors and their creditors…To address these concerns, the Commission has

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undertaken to develop a Proposal which will both expedite the process for debtors that can be saved, and conclude the process quickly for those which cannot benefit from the protections of Chapter 11.

Many of the NBRC's recommendations were enacted in 2005 as part of BAPCPA:

- Section 101 (51D) of the Bankruptcy Code now contains a definition of "small business debtor" as one with aggregated debts of $2.19 million[4];
- New section 1116 establishes duties of the trustee or debtor to strictly conform to a schedule for producing critical financial documents, attend scheduled court and administrative meetings, pay its taxes, and conform to relevant Bankruptcy Rules;
- Section 1121(d) provides a small business debtor with a longer period in which it has the exclusive right to file a plan of reorganization, but makes any extension of that deadline contingent on establishing, by preponderance of the evidence, that the court is likely to approve a plan within a reasonable time; and
- General amendments to the conversion and dismissal criteria contained in Section1112 of the Code define as "cause" for dismissal a series of circumstances (e.g., failure to maintain appropriate insurance coverage, attend meetings or examinations, pay taxes, or file disclosure statements) that are more likely to occur in a small business case, while also providing small business debtors with a general defense to dismissal if they can establish that there is a reasonable likelihood that a reorganization plan will be confirmed within statutory timelines.

Again, the NBC report contains no extended discussion or serious evaluation of the 2005 small business amendments, referring to them with the glib dismissal, "Chapter 11 includes a set of procedures (due in part to the reforms of 2005) that create serious roadblocks to reorganization."

Later on the NBC report states:

BAPCPA appears to have placed additional demands on the cash flow of Chapter 11 debtors. Sections 366(b), (c). and 503(b)(9) of the Bankruptcy Code now require the debtor to deposit cash sufficient to offer "adequate assurance" to utility suppliers and to give administrative expense priority to claims for goods supplied within 20 days of the bankruptcy petition. Although no empirical work has studied these sections yet, they likely impose larger burdens on small businesses than large firms because small businesses appear to face greater borrowing constraints.38 Put differently, Sections 366(b) and 503(b)(9) increase the cost of Chapter 11 by forcing a small business to generate sufficient cash flow to cover these requirements immediately...BAPCPA's new requirements with respect to administrative expenses and adequate assurance effectively tax the cash flow of cash strapped businesses, undermining chances for successful reorganization.

These provisions cited by the NBC are of general application and not exclusive to small businesses. They were enacted by Congress to provide better protection to providers of basic utilities as well as unsecured trade creditors. The report fails to explain why a small business incapable of paying its electric bill on an ongoing basis, or its suppliers of basic goods and materials as a condition of plan confirmation, can be expected to successfully

[4] The 2005 debt cap was $2 million, since indexed for inflation; the NBRC had recommended a debt cap of $5 million.

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reorganize; much less why it should be permitted to linger at length in Chapter 11. As the NBC report concedes, its criticism of these protections is based on "no empirical work," notwithstanding that these provisions of law have been in effect for nearly five years. In any event, shifting small business bankruptcies from Chapter 11 to 12 will not trump the right of utilities to receive adequate assurance of payment under Section 366(b) of the Code, nor will it erode the administrative expense priority of trade creditors, so its mention is largely superfluous and irrelevant.

Inexplicably, the NBC report attempts to establish "basic facts" about current small business bankruptcies by referring only to studies dating from 2006 or earlier, thereby omitting any meaningful data on the influence of the 2005 amendments, not effective until October of that year. Congress would be putting the cart before the horse by considering anything as far-reaching as the NBC recommendation without first conducting an empirical review of the effects of the 2005 small business amendments, as well as a well-documented evaluation of recent Chapter 11 filings, to discern whether any meaningful percentage of small business debtors could successfully reorganize under different statutory provisions that maintain a reasonable balance between debtor and creditor interests.

The NBC report does note that several NBRC small business recommendations were incorporated within BAPCPA, but is critical of them because they do not further the NBC's goal of diminishing the bankruptcy rights of small business creditors:

[T]he Commission recommended, and BAPCPA adopted, various measures to give the U.S. Trustee greater power to monitor small business cases and to increase the information available to the court and Trustee. For example, the U.S. Trustee is now instructed to investigate the debtor's viability at the outset of the case, and the debtor is instructed to submit periodic financial reports and schedules, attend all meetings, timely pay taxes, and maintain insurance. Although BAPCPA extended the exclusivity period (from 100 to 180 days) and deadline for submitting a plan (from 160 days to 300 days44)—contrary to the Commission's recommendation—the Act imposed a new 45-day deadline for achieving plan confirmation. These changes increased the obligations on small businesses but did not necessarily create the conditions to facilitate reorganization. Furthermore, BAPCPA reduced judges' discretion in determining whether to dismiss or convert chapter 11 cases even though the empirical research reviewed earlier suggests that courts had good track records of sorting viable and nonviable cases.

The National Bankruptcy Review Commission addressed High Costs to some extent by recommending that disclosure statements be simplified or eliminated in small business cases and that courts promulgate standardized disclosure statements and reorganization plans. The first recommendation found its way into BAPCPA, and there are now Official Forms for small business plans and disclosure statements. Although this was a useful step, it did not address the many other ways in which Chapter 11 produces considerable administrative costs in small business cases.

Notwithstanding this NBC commentary, the documents now required of small businesses are the types of basic financial statements and plans that are critical to any successful reorganization effort. Of course they do not "create the conditions to facilitate reorganization" – only a viable business plan and adequate cash flow can do that. It is also impossible to square the NBC Report's assertion that "courts had good track records of sorting viable and nonviable cases" with the NBRC's finding that "studies reveal that

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Chapter 11 debtor often live under the protection of the Bankruptcy Code for literally years, often without providing any meaningful return to unsecured creditors." The NBRC did not recommended modern case management techniques for the purpose of reducing judges' discretion but to more quickly separate viable from hopeless cases.

Collateral Costs To Society Of The Chapter 12 Approach

Indeed, the NBRC found that permitting non-viable small businesses to linger in Chapter 11 had negative societal consequences extending far beyond the business' creditors:

The Working Group has received considerable anecdotal data supporting its conclusion that numerous debtors, suffering from cash shortages, finance their day-to-day operations by using cash withheld from employee paychecks or sales-tax revenues, or other like "trust fund" taxes, to pay bills and provide the business with working capital. This chronic problem is often witnessed by Chapter 7 trustees in cases converted from Chapter 11.

Allowing non-viable small businesses to linger in bankruptcy means that they will likely operate without properly maintaining equipment, paying insurance and workers' compensation insurance premiums, or satisfying their tax obligations. Abridging creditor rights does nothing to provide a small business lacking adequate cash flow with the means to address these matters of safety and social obligation.

While touting Chapter 12 as a viable small business reorganization alternative to Chapter 11, the NBC fails to note the very significant collateral costs to society that were ascribed to that approach in a 2006 Congressional Research Service Report[5]:

Chapter 12...has special provisions for farmers compared with other bankruptcy chapters, strengthening farmers' bargaining position with creditors. Chapter 12 is more about reorganization of debt than bankruptcy because it allows secured debts to be written down to the fair-market value of the collateral and repaid at lower interest rates over extended periods...Chapter 12 has succeeded in keeping some farmers in business and has encouraged informal lender-farmer settlements out of court. But it has increased costs to society by encouraging inefficient farmers who would otherwise liquidate to remain in business, and allowing efficient farmers who could otherwise continue to farm to charge off part of their debts. Bankruptcy costs include legal fees and efficiency costs from continuing to use labor and capital in otherwise inefficient enterprises.

Indeed, these and other negative impacts of Chapter 12 were noted by an analysis of its impact on farm lending published four years after its enactment:

It is doubtful that there currently exists a single provider of funds, farm supplies, and/or agricultural services which has not been directly or indirectly impacted by the advent of Chapter 12. Indeed, some major suppliers of fuel, seed, fertilizer, and chemicals, operating as large-scale holders of unsecured claims on agricultural producers, have been forced into Chapter 7 liquidation as a result of their customer's treatment under Chapter 12. In our highly integrated and interdependent agricultural economy, it would appear that the domino theory is well supported by recent experience...While Chapter 11 contained provisions for protecting an under-

[5] "Agricultural Credit: Institutions and Issues"; Jim Monke, Analyst in Agricultural Policy, CRS; Order Code RS21977; Updated September 14, 2006.

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secured creditor, wherein that creditor could opt for potential appreciation in collateral value rather than receiving payments on its under-secured claim, Congress chose to exclude such provisions from Chapter 12, thus conveying to farmers the entire windfall associated with future increases in the value of farmland. As a result, the once-secured creditor is left with only the collateral value of the secured claim amount, without an opportunity to recover any losses from future appreciation... The write-down, or cram-down, provision forced a downside risk on real estate lenders under Chapter 12, while it conveyed all upside benefits to the farmer... While Chapter 12 appears to have provided some short-run benefit to those family farmers in crisis, it has obviously become a burden to secured creditors. In large part, they have lost their ability to force a liquidation and thereby ensure themselves receipt of the secured portion of their claims... This creates a unique financial scenario wherein the secured creditors must bear the risk for any future downside risk on their farm investment, while unsecured creditors gain from any short-run upside trends and farmers, themselves, are the primary recipients of any long-run upside improvements. Below market rates of interest allowed by the courts only serve to accelerate the costs of the secured claimants... FmHA, the Farm Credit System, insurance companies, and commercial banks have all been adversely impacted by Chapter 12... it must now be recognized that Chapter 12 has rigidly institutionalized those losses with those lenders, as gains from improved land values are accruing solely to the farmer. In brief, suppliers of agricultural funds, supplies, and services were asked to bear the downside burden and denied access to any upside gains. Therefore the true impact of Chapter 12 on our nation's agribusiness firms is very real, quite large, and potentially long lasting. And what about the farmers receiving such assistance? No doubt, some will recover and survive as viable enterprises. But others who received dramatic relief may remain for years as financially vulnerable operations with continued low levels of equity.[6]

Conclusion

Adoption of the NBC's recommendation would constitute a highly risky experiment for the small business sector and the U.S. economy at the very time when Congress is seeking to ensure that small businesses have adequate access to affordable credit to sustain their critical role of generating new jobs.

<u>As the NBC report concedes, enactment of their proposal would cause a huge shift in business bankruptcy practice as Chapter 11 filings migrated to Chapter 12:</u>

As SBEs begin using Chapter 12, the caseload of Chapter 12 trustees will increase dramatically. There were only 345 Chapter 12 filings but nearly 10,000 Chapter 11 cases during calendar year 2008. The bulk of Chapter 11 cases are filed by small businesses.

In fact, it was estimated that the 2005 small business provisions, which set a ceiling of $2 million in debt or less as defining a small business, encompassed a large majority of all Chapter 11 cases – so the NBC proposal, with its $10 million debt ceiling, would probably displace the vast majority of all Chapter 11 cases, reserving its proven reorganization framework for only the largest corporations[7]. Indeed, Judge Bennett testified that, by his

[6] Duft, Ken D.; "Chapter 12 Bankruptcy in Retrospect: Its Impact on Agribusiness Firms; Agribusiness Management, Washington State University, Pullman; August 1990. Available at http://www.agribusiness-mgmt.wsu.edu/ExtensionNewsletters/cash-asset/Chap12.pdf.

[7] Judge Bennett noted that the NBC's flawed definition of what constitutes a small business could also open Chapter 12 to hundreds of very large enterprises – including some with assets in the hundreds of $millions range, and several with assets exceeding $1 billion!

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calculation, 87 percent of all the Chapter 11 cases filed in 2009 would have been eligible for Chapter 12 using that definition of "small business." At current filing rates Chapter 12 cases would increase about thirty-fold – in reality, the increase could be even larger as Chapter 12's more generous provisions would likely entice many failing small businesses to attempt reorganization rather than properly enter into Chapter 7 liquidation or utilize state insolvency laws. This would be a sweeping sea change for U.S. business bankruptcy policy, of questionable judgment on both policy and administrative grounds. For example, it is not at all clear that the thousands of skilled trustees required to manage Chapter 12 cases could be readily found.

It would be irresponsible to consider this proposal seriously, much less enact it, without first making a far more serious inquiry into the potential viability of those small businesses currently filing in Chapter 11, as well as the impact on the 2005 small business bankruptcy amendments on their prospects for successful reorganization. There is strong reason to concur with Judge Bennett's conclusion that "the NBC proposal is flawed and based on incomplete and not demonstrably accurate and verifiable data" and his recommendation that

> the NBC proposal should not be implemented without further investigation into several aspects...One is a proper consideration and analysis of the repercussions on the cost of borrowing and job losses and gains which would be expected to occur following enactment...Another is that the definition of what is a small business enterprise needs to be redone to ensure that it does not encompass what are truly big businesses...Without further investigation, one may only speculate, rather guess, at many of the "basic facts" of small businesses and at the so-called "fundamental flaws" in the Chapter 11 process for small business.

To Judge Bennett's list could be added the imperative need for a serious study and analysis of the impact of the 2005 small business bankruptcy Chapter 11 changes enacted in BAPCPA, and of whether the difficulties of achieving successful reorganization in Chapter 11 lie in its statutory provisions or in the economic and managerial characteristics of the majority of small businesses who file under that Chapter of the Code.

Small business lenders should stand ready to work cooperatively with Congress to consider further changes to the Bankruptcy Code that may facilitate small business reorganizations. Indeed, lenders prosper when their small business customers have increased ability to exit bankruptcy and resume full operations in more viable form. But any such proposals must be based upon empirically sound findings, must preserve essential creditor rights and an overall balance between debtors and creditors, and must fully consider their potential impact on small business access to the credit markets. Given the high stakes for debtors, lenders, job growth and the economy, any approach lacking such a firm foundation would not be a responsible path leading to sound policy decisions.

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Testimony of

Hon. Thomas B. Bennett
United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Alabama
Birmingham, Alabama

before
Senate Committee on the Judiciary, Subcommittee on Administrative Oversight and the Courts

"Could Bankruptcy Reform Help Preserve Small Business Jobs?"

March 17, 2010

Subcommittee Chairman Whitehouse, Ranking Member Sessions, and Members of the Subcommittee, I want to thank you for the opportunity accorded me today. A few caveats to my remarks are necessary. I want to make it clear that I am expressing my views. They are not those suggested to me by others. Similarly, I appear in my individual capacity and not as a representative, member, or officer of any group or organization.

This Subcommittee is considering changes suggested by the National Bankruptcy Conference to Chapter 12 of the Bankruptcy Code, 11 U.S.C. §§ 1201 et seq. and related provisions set forth elsewhere to make them consistent with the proposed modifications to Chapter 12. The espoused goal is to allow what is called a "small business enterprise" to more easily and at less cost reorganize its financial affairs in a bankruptcy proceeding in lieu of liquidation of her/his/its business in either a federal bankruptcy setting or under state law based methods of liquidating a business. At least part of what the Subcommittee is considering is whether the offered amendments to Chapter 12 would, if enacted, enable such businesses to reorganize and save jobs which might otherwise be lost. Given the current state of the economy, this is both a warranted consideration and one which deserves careful analysis based on data that is demonstrably sound and verifiable. Furthermore, the look at what the offered changes could do should not be limited to the context of what happens in the vacuum of a bankruptcy case or cases. Rather, the broader economy-wide impact of the proposed changes must be considered when analyzing alterations to the bankruptcy laws which have the scope and depth of what is offered by the NBC.

As a preliminary comment, it is and has been clear for decades, if not longer, that Chapter 11of the Bankruptcy Code, 11 U.S.C. §§ 1101 et seq., and predecessor provisions under the Bankruptcy Act of 1898, as amended, principally Chapters X and XI, do not and did not allow some businesses to reorganize their financial affairs in a timely and efficient manner and at

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a cost that is affordable. The reality of the legal process in a bankruptcy case is that it is sometimes, but not always, too slow and cumbersome. It is also sometimes accurate that the costs may be too great for a business entity or an individual to pay and simultaneously reach a successful reorganization. This is sometimes true for some small cases in terms of debts and assets and in some instances for large ones. That these too costly, too cumbersome, too slow factors are accurate for some Chapter 11 bankruptcy cases does not, standing as the only bases, support changes that would encompass, if the National Bankruptcy Conference's proposal is enacted, the majority of all Chapter 11 cases filed in 2009. The sometimes slowness, the cumbersome nature, and the costs of a bankruptcy case are not unique to bankruptcies. Unfortunately, the same is true for many areas involving the legal process.

Recognizing that Chapter 11 does not work well for certain types of bankruptcy cases is one thing, the implementation of change to improve reorganizations under the Bankruptcy Code is another and more difficult task. The National Bankruptcy Conference and the members of its Small Business Working Group (hereinafter collectively the "NBC") have undertaken the more difficult task and are to be commended for the effort. Although the proposal by the NBC envisions utilizing what has been used in Chapter 12 for family farmers and family fishermen with regular income and what is similar for treatment of businesses of individual debtors with a regular income under the provisions of Chapter 13 of the Bankruptcy Code, the NBC's suggestions are too broad in scope and made without use of data that is demonstrably accurate or verifiable for purposes of changing a statute with nationwide application.

It needs to be emphasized that a lot of what is the cause of the lack of demonstrably accurate and verifiable data should not be and is not the fault of the NBC. Rather, it is the result of a failure to collect in a meaningful and utilizable form financial and other data that could be obtained from bankruptcy filings. It is not that difficult to have those with expertise – and this means others than lawyers and judges – design bankruptcy forms which would solicit relevant data in a format that allows its extraction and manipulation in a mathematically meaningful manner and from which could be generated analyses of innumerable issues which are faced in the insolvency arena. Unfortunately, this has not been and is not being done to the extent it should have already occurred. The result has been and continues to be consideration of bankruptcy legislation designed and offered for a purpose or purposes for which unverifiable and sometimes inaccurate assertions are made. This is true for some of the 2005 amendments to the Bankruptcy Code, many of the proposed amendments regarding mortgage modifications made since 2008, and, unfortunately, the proposal to modify Chapter 12. The absence of such data has and continues to allow assertions to be made which are based on non-statistically valid extrapolations of data from so-called samples of factors in bankruptcy cases. In the context of the proposed small business enterprise amendments to Chapter 12, this is also the case.

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1. Lack of Random Sampling on which Conclusions Premised, Overly Broad Application which Includes Even Very Large Bankruptcy Cases, and Potential Economic Effects.

A. *The Data and Extrapolation Problems.*

As pointed out, the NBC had the difficult task of forming a proposal based on the unavailability of data generated from a truly random sample of business bankruptcies across the United States. This is evidenced by examination of the sources referenced in the NBC's "Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize" (hereinafter the NBC Proposal). Many of the significant factual assertions denominated in the NBC Proposal as "basic facts" of small business chapter 11 cases are derived in significant part from studies discussed in three articles: Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005) (hereinafter sometimes the IL Study), Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study*, working paper (2007) (hereinafter sometimes NY/AZ Working Paper), and Elizabeth Warren & Jay Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009) along with Elizabeth Warren & Jay Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L. J. 499 (1999) (hereinafter sometimes the Multi-District Study). These articles are used by the NBC as evidence that what was the purported state of affairs for business bankruptcy cases filed in one bankruptcy court in one division of one district in Illinois, one district in New York, that of the state of Arizona, and the twenty-three districts utilized in the Multi-District Study is the state of affairs for business bankruptcy cases filed in all bankruptcy courts in all districts of the United States. The problem is that the IL Study is just that, a study of certain business bankruptcy cases, 112 of 184 which was reduced further to 91 cases, filed in the Eastern Division of the Northern District of Illinois during 1998. Similarly, the NY/AZ Working Paper looks at certain bankruptcy cases filed in the Southern District of New York and the District of Arizona in the period of 1995 to 2001, and the Multi-District Study was premised on cases filed in 1994 in twenty-three districts selected by the authors based on criteria believed appropriate for the selection of these districts.

The important restriction in each of these studies and their use by the NBC is that none purport to be based on a sampling of business bankruptcy cases drawn on a statistically random basis which is representative of all jurisdictions of the United States. Thus, the NBC's use of these to arrive at its "basic facts" of small business bankruptcy cases and its conclusions for all small business bankruptcy cases is inapt, to say the least. The most that can be said from these sources is that they represent the then state of affairs in the districts which were looked at which is less than the majority of those in the United States. Indeed and as will be pointed out later, the most that may be gleaned from these studies is that the then make up of business bankruptcy

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cases in these districts may or may not represent the "basic facts" premised in the NBC proposal. In point of fact in one of the NBC's relied on studies, Professors Warren and Westbrook expressly set forth when discussing the usability of their asset data for business bankruptcy cases that:

> "...Th[eir] design, however valuable for talking about Chapter 11 cases or for comparing them with other types of cases, does not permit extrapolation to the entire nation.
>
> The best way to understand the national picture is to have a representative sample of filings, an undertaking beyond the resources of individual researchers and an undertaking to which the government has not yet committed its resources...."

Warren & Westbrook, *Financial Characteristics of Businesses In Bankruptcy*, 73 Am. Bankr. L. J. 499, 520 n.47 (1999). This same limitation on use of the Multi-District Study information is made for business bankruptcy debts in footnotes 56, 57, and 58 of this article.

Despite the Multi-District Study authors'explicit recognition of the problems in extrapolating the data collected from twenty-three districts to the entire United States, they did just what should not be done by determining what the Chapter 11 cases filed in the twenty-three districts constituted as a percentage of all such cases filed in the United States for the period considered. In their study it was 7.7%. Therefore, they multiplied the number of cases in these twenty-three districts by 13 to arrive at the purported national composition of all Chapter 11 cases. Some of what is in the Multi-District Study's incorrectly projected data has been used in the NBC Proposal.

Coupled with the fact that the Warren & Westbrook sampling was not random in the statistical meaning of the word, what the authors did was make the minority of bankruptcy jurisdictions the substitute for all bankruptcy jurisdictions with cases in all having only the characteristics of cases filed in the twenty-three districts utilized whether characteristically right or wrong for analysis of these cases on a national basis. This extrapolated data is then used in the discussion of business bankruptcies. Also set forth in footnote 47 of this Warren and Westbrook study is a caveat wherein the authors state that the data regarding Chapter 11 business case liabilities is not offered because they believe it to be correct. This caveat is also repeated for assets of Chapter 11 business bankruptcies in footnotes 56 and 57. The following is also incorporated in footnote 47:

> <u>...The reader should understand that this extrapolation is fraught with danger because we deliberately omitted the "average" or "typical" districts by concentrating on high-filing and low-filing districts. More technically, the procedure makes strong assumptions about the homogeneity</u>

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> of cases across districts. We ourselves believe that these assumptions are subject to challenge and have previously demonstrated the existence of a local legal culture in bankruptcy filings. [Emphasis Supplied].

Warren & Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L. J. at 520 n.47.

This extrapolation error is identical to the error in the NBC Proposal for many of the so-called "basic facts" of small business bankruptcies. The NBC has used data derived from a non-random collection of data in some of the studies cited for the district(s) surveyed and most assuredly not a random sampling of all Chapter 11 business bankruptcy cases filed in the United States. As will be pointed out, the use of non-randomly collected data from some jurisdictions does not support the NBC's "basic facts." The best that may be said is that these "basic facts" may or may not be representative in some instances! Because the NBC Proposal is a major restructuring of the bankruptcy process, the changes are of too great impact both within and outside the bankruptcy process to be premised on any extrapolation of incomplete and unrepresentative samples.

B. *Potentially Contrary and Overlooked Findings.*

This absence of a valid methodology that is verifiable brings into question the NBC Proposal's authors' assertion that there are four fundamental flaws in the current reorganization process for small businesses. The contentions in the small business context are that (1) there is excessive secured creditor influence in Chapter 11, (2) the Chapter 11 process does not give the judge or trustee/bankruptcy administrator sufficient information to monitor the firm's viability, (3) Chapter 11 generates exorbitant administrative costs, and (4) Chapter 11 contains procedures that create serious roadblocks to reorganization. NBC Proposal at 3. In addition to the fact that these contentions are premised on data which is not properly extrapolated and not properly capable of a valid extrapolation, is the fact that one of the studies relied upon by the NBC Proposal, the IL Study, reached conclusions with respect to Chapter 11 small business cases studied diametrically the opposite of those in the NBC Proposal.

In the IL Study, Professor Morrison sets forth a summary of what he found for small business bankruptcy cases filed in the Eastern Division of the Northern District of Illinois in 1998. What is set forth in this summary is at odds with the traditional view of Chapter 11 and the NBC Proposal's authors' "fundamental flaws" contentions regarding small business Chapter 11 cases:

> . . .In this paper, I present evidence that challenges the traditional view as it applies to small-business Chapter 11 cases. Using a sample of all corporate Chapter 11 filings in the Chicago area during 1998, I find that the direct and indirect costs of small-business Chapter 11 cases are small. Nearly 60 percent of these businesses were shut down. The

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> court either dismissed the chapter 11 case, permitting liquidation under state law, or converted it to a Chapter 7 proceeding...which mandates automatic liquidation. Among businesses that were shut down, the decision to dismiss or convert the case came quickly. For 50 percent of these businesses, the shutdown decision was made within 3 months of filing. For 70 percent, it was made within 5 months. For businesses that failed, then, the Chapter 11 process was remarkably short. As a general matter, it [the Chapter 11 process] took no more time than did rival procedures.
>
> Moreover, the Chapter 11 process appears to sort effectively between businesses that are viable and those that are not. Biases commonly ascribed to the system are largely absent from the data. Neither creditors nor debtors (managers or equity holders) dominate the bankruptcy process. Instead, bankruptcy judges play a major role in filtering failing businesses from viable ones, and they appear to be able to do this job well.
>
> * * *
>
> Finally...[and] [t]aken together, these findings suggest that the small-business Chapter 11 process has significantly lower cost and displays significantly less bias than is commonly thought. [Emphasis Added and Footnotes Omitted].

Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies,* 50 J. L. & Econ. 381, 382-83 (2007).

Although Professor Morrison's article was used in part by the NBC to find certain of the "basic facts" which lead in part to the inferred "fundamental flaws" of small business reorganization in Chapter 11–an inferential process which is fundamentally flawed, the NBC Proposal apparently overlooks his study's conclusions which indicate that certain of the NBC Proposal "basic facts" and the so-called "fundamental flaws" of small business Chapter 11 cases are incorrect for those small business cases studied in Illinois. Should a proper sampling of small business Chapter 11 cases for nationwide application achieve the same results as those of Professor Morrison in his Eastern Division of the Northern District of Illinois, no less than three (3) of the four (4) ascribed "fundamental flaws" of Chapter 11 in the small business bankruptcy case context would be incorrect. The three (3) are excessive secured creditor influence, monitoring deficits by judges, trustees or bankruptcy administrators due to insufficient information to monitor a firm's activities, and exorbitant administrative costs.

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C. *The Small Business Definition Inconsistencies.*

Part of the problem with the NBC Proposal is that the definition of what is a small business is not consistent between the proposed NBC inclusion of corporate and non-corporate persons engaged in a business or commercial activity with total debts not exceeding $10,000,000.00 and those used by others. For instance, the IL Study eliminated from its small business classification certain cases by the type of debtor involved, e.g., individuals, single asset real estate entities, non-business filings by individuals, sale of asset cases and dispute settlements via Chapter 11, dead on arrival firms, insufficient information cases, and publicly traded companies. What is important is that with the exception of two large publicly traded businesses, the total debt of the cases included in the IL Study was not an elimination or inclusion factor. See Edward R. Morrison, *Bankruptcy Decision Making,* 50 J. L. & Econ. at 383-89. The same may be said about the Multi-District Study which accumulates debt data by various dollar categories and calls bankrupt business debtors very small if total debt is under $100,000.00 and small if debt is $100,000.00 to $500,000.00. See Warren & Westbrook, *Financial Characteristics of Businesses in Bankruptcy,* 73 Am. Bankr. L. Rev. at 523-29. The reason why the NBC selected the total debt figure of $10,000,000.00 for small business bankruptcy cases is not delineated in the proposal, nor are the consequences from using such a dollar amount.

It is the NBC Proposal's $10,000,000.00 definition of what is a small business for Chapter 12 inclusion which causes its adoption as offered to have far greater consequences than is discussed in the bankruptcy case context. In Table 3 of the Multi-District Study, the $10,000,000.00 debt level would include more than 96.9% of all Chapter 11 cases filed in 1994 if that data is correct. In the IL Study and although not broken out in a manner that allows a determination for the $10,000,000.00 level of debt, what is ascertainable is that 68.4% of business bankruptcy cases included in the study had total debt of under $1,000,000.00 and that the median debt was $511,752.00 with a mean debt level of $2,429,858.00. Both the Multi-District Study and the IL Study suggest that a debt level of $10,000,000.00 for Chapter 12 would allow all but a minority of the 12,799 Chapter 11 cases filed in 2009 to have been filed under Chapter 12 if the NBC Proposal were to be followed.

At my request, information was provided to me on March 11, 2010, by the Administrative Office of the United States Courts regarding debt and asset levels of Chapter 11 cases filed in 2009. The data is set forth on two schedules which accompany this written testimony. One is derived from Official Form 1 for bankruptcy cases which asks for information by ranges for both assets and liabilities. This schedule is captioned "Case Counts by Estimated Asset & Liability Codes" (hereinafter the Cover Sheet Summary). The other is taken from Official Form 6 for

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bankruptcy cases. It is captioned "Case Count by Listed Dollar Values (Summary of Schedules)" (hereinafter the Summary of Schedules Summary). This data is organized to show not just total debts and total liabilities of cases filed in 2009 under Chapter 11, but to also allow one to compare the range of cases by assets which would be included within the $10,000,000.00 NBC Proposal's small business classification.

One needs to know that the information set forth on both the Cover Sheet Summary and the Summary of Schedules Summary (collectively the Summaries) is what was provided by the debtors on the cover sheet and the summary of schedules. It is not checked for debtor accuracy which is a problem with the data because the Summaries indicate data inconsistencies and other problems. The reason this information was requested in this format is because data that was used in some of the studies relied upon by the NBC in reaching its "basic fact" and "fundamental flaw" determinations was taken from these sources, but for different years.

The Cover Sheet Summary numbers show that at the $10,000,000.00 debt level for Chapter 12 "small business entities," as many as 8,546 Chapter 11 cases filed in 2009 would have been eligible for filing under Chapter 12. This is 67% of all cases filed. It also reveals that it would allow the small business classification for Chapter 12 to conceivably include three (3) cases with scheduled assets of over $1,000,000,000.00, seven (7) cases with assets of between $500,000,000.01 to $1,000,000,000.00, twenty-one (21) cases with assets of $100,000,000.01 to $500,000,000.00, thirty-four (34) cases with assets between $50,000,000.01 to $100,000,000.00, and two hundred sixty-three (263) cases with assets ranging from $10,000,000.01 to $50,000,000.00. This totals three hundred twenty-eight (328) cases. The overwhelming majority of these most likely should not be encompassed in any definition of a small business. Furthermore, these numbers do not take into account that the NBC Proposal excludes debts owed to insiders and affiliates from the $10,000,000.00 amount. Thus, additional large bankruptcy cases in the remaining 4,253 Chapter 11 cases filed in 2009 with total debts above $10,000,000.00 accompanied by even greater asset values would possibly be able to utilize the NBC envisioned Chapter 12. This is not a picture of a small bankruptcy process under Chapter 12.

The Summary of Schedules Summary also presents a snapshot for 2009 that indicates even more cases filed under Chapter 11 would have been able to file Chapter 12 under the NBC Proposal. It reveals that based on the numbers set forth on the summary of schedules – again, these numbers have problems – as many as 11,148 of the total of 12,799 Chapter 11 cases filed in 2009 could have utilized Chapter 12 had the NBC Proposal been in effect. This is over eighty-seven percent (87%) of all Chapter 11 filings. To show the scope of the data problems from these sources, one need only look at the Summary of Schedules Summary. It reveals that in 5,411 Chapter 11 cases filed in 2009 assets were disclosed on the summary at zero for both real

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and personal property categories and that in 5,112 cases that liabilities were scheduled in the summary as zero for each of the secured, unsecured priority, and unsecured non-priority classifications. Regardless of these problems, this information is set forth because it is some of what was used, although for different years, in some of the studies on which the NBC Proposal is based. It further highlights the difficulty for data accumulation in an accurate and verifiable manner in bankruptcy cases and why certain of the "basic facts" and "fundamental flaws" assertions are suspect for small business Chapter 11 cases.

D. *The Broader Economic Implications Not Discussed.*

More consequential than the reliability of the facts or the foundation for the conclusions in the NBC Proposal is that, regardless of which data is utilized, all indicate that the proposal has much broader application than making reorganizations of small businesses easier, faster, less costly, and with fewer burdens, if in fact it would do so. The single most important aspect of what is being suggested is that it would be a major restructuring of reorganizations under the Bankruptcy Code which would enable the vast majority of cases currently filed under Chapter 11 to be filed under an expanded Chapter 12. Yet, the NBC Proposal does not discuss the greater economic implications of such a change on various aspects of bankruptcy and how markets may be impacted, including the cost of credit for both bankrupt and non-bankrupt entities.

To understand why this must be considered, one must understand the fundamental difference in the Chapter 11 approach to reorganization and that of Chapter 12. Chapter 11 is designed to obtain, if possible, a consensus between debtors and creditors. In re: Adelphia Commc'ns. Corp., 352 B.R. 578,586 (Bankr. S.D.N.Y. 2006); see also In re: Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660, 667 (Bankr. D.D.C. 1992); 7 Collier on Bankruptcy ¶ 1100.01[6] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev.). This is done via several of the bankruptcy law provisions in Chapter 11 dealing with plan requirements, confirmation of a plan, and is epitomized by the voting requirements. In fact, creditors in a Chapter 11 case have the ability under § 1121 to propose a plan on the expiration of certain time periods without a debtor plan having been submitted or accepted. This means that creditors have input into the reorganization process and the potential ability in some instances to veto a debtor's reorganization efforts. See, e.g.,11 U.S.C. §§ 1121-1129. In the event that what is called a consensual plan–one agreed to by the requisite number of creditors holding the necessary dollar amount of claims in all classes of creditors–is not achieved, Chapter 11 has a limited means of confirming a plan via what is called the cram down process in 11 U.S.C. § 1129(b). However, this process still requires that at least one class of impaired creditors, excluding insider classes, vote in favor of the plan. See 11 U.S.C. § 1129(a)(10) & (b)(1). In many cases this cram down requirement is easily achieved, but it is not met in all Chapter 11 cases.

Although not given much credence by a few, part of Chapter 11's design is to allow creditors and others input into what a Chapter 11 debtor plans to do to reorganize. It enables

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creditors and others to evaluate a debtor's financial condition and business practices along with being able to comment on the proposed financial plan and business plan for the hoped for reorganization. In many cases, a creditor's/party in interest's reviews and suggestions bring to a debtor insight and expertise not otherwise available. This permits a Chapter 11 debtor to correct errors in a plan and business operations and improves the reorganization effort. The process simultaneously gives the creditor and others potentially more faith that the debtor's reorganization efforts have the ability to succeed. In other cases, this non-debtor input helps a debtor learn that reorganization as he/she/it contemplates will not be successful. This is only some of what is lost under the NBC Proposal for small business bankruptcy cases.

In contrast to Chapter 11, creditors face the fact that Chapter 12 is designed to give only the debtor the right to propose a plan, 11 U.S.C. §§ 1221 & 1223, and it is not based on trying to achieve a consensus between the debtor and his/her/its creditors. Rather, the concept is to allow a debtor to go forward with a plan designed by the debtor within the framework of what Chapter 12 allows to occur. The creditors may object to a plan, but the objections are limited to failures to comply with what is required to be met under the debtor's Chapter 12 plan and certain other applicable provisions of the Bankruptcy Code to Chapter 12. Thus, it is not a chapter of the bankruptcy laws which requires or contemplates agreement among creditors and the debtor on how a case should be confirmed. See 11 U.S.C. §§ 1221-1229.

From a creditor's perspective, this is a change of import. Conjoined with this is the fact that significant differences exist in Chapter 12 under the NBC Proposal for small business entities from what creditors face today in Chapter 11 including, but not limited to: adequate protection under § 361 of the Bankruptcy Code is modified in Chapter 12 and places a creditor at greater risk of loss; uses, sales, and leases of property free and clear under § 363 are expanded in Chapter 12 allowing, among other things, greater ability to sell a creditor's collateral than in a Chapter 11; and restrictions on conversion of a Chapter 12 case under § 1208 to one under Chapter 7 that do not exist under 11 U.S.C. § 1112 for Chapter 11 cases. These and other differences between Chapter 11 and Chapter 12 are in economic parlance non-price changes which increase the potential for additional losses by a creditor. In other words, they increase the risks of a bankruptcy when viewed from a creditor's position.

If all other factors affecting the supply of credit are held constant, what happens in the market place is that the supply of credit shifts to the left relative to what was the equilibrium point between the supply and demand for credit. It is a reduction in the supply of credit from where it was before. More simply, these sorts of changes absent some other offsetting factor or factors cause credit to be more expensive for all borrowers than it would otherwise be. The Subcommittee Members should not be lead astray by statements that in other contexts interest rates went down such as some proffer occurred following increased regulation of credit card terms. The reason is basic: the fact that interest rates increase or decrease is driven by numerous factors including the aggregate amount all lenders are willing to loan and all borrowers want to

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borrow. To appropriately analyze what happens to interest rates when increased risk and costs are put into play, one must isolate all the other causes for changes in the supply and demand for credit. When this is done, one may ascertain that increased risk caused an increase in the cost of borrowing above what it otherwise would have been even though interest rates fell and likewise resulted in a greater increase in the cost of credit when interest rates rise. What is often covered up by looking at the overall direction of interest rates, up or down, is the fact that an increase in risk in a falling cost of credit market results in rates decreasing less than they would have otherwise fallen and in an increasing interest rate environment rates increasing more than they otherwise would have.

The correlative to this cost of credit effect is that at every given point on the curve that pictures the supply of credit at various prices, the supply of credit would be less than it otherwise would have been, but for the increase in risk associated with a change in small business bankruptcies under the NBC Proposal. The bigger picture outside bankruptcy cases is that unless benefits to creditors are created that offset in full the increase in risk, perceived and actual, under the NBC Proposal, one should expect the supply of credit to be less than it otherwise would be. The implications of changing the reorganization structure under the Bankruptcy Code for the vast majority of what would have been Chapter 11 cases to one under the NBC Proposal's Chapter 12 has outcomes that may be contrary to what this Subcommittee wants. Absent knowing more, the NBC Proposal might result in a decrease in job creation outside the bankruptcy context that exceeds any gain, if any at all, within the bankruptcy context. This is far too weighty an issue to not have been considered in the NBC Proposal and is far too momentous of a potential outcome to ignore in the framework of fundamentally altering how a majority of businesses reorganize under our current bankruptcy laws.

E. *Some of the More that Needs to Happen.*

The upshot of this discussion is that the NBC Proposal should not be implemented without further investigation into several aspects of its proposal. Because of time constraints, only some will be mentioned. One is a proper consideration and analysis of the repercussion on the cost of borrowing and job losses and gains which would be expected to occur following enactment of the NBC Proposal. This is perhaps the most critical. Another is that the definition of what is a small business enterprise needs to be redone to ensure that it does not encompass what are truly big businesses. One more is obtaining demonstrably accurate and verifiable data regarding small businesses in the United States and not just from improper extrapolation of data from parts of the United States to the whole. Without further investigation, one may only speculate, rather guess, at many of the "basic facts" of small businesses and at the so-called "fundamental flaws" in the Chapter 11 process for small businesses. Manifestly far more serious are the reverberations that may occur outside bankruptcy from such a fundamental change in how business bankruptcies may be handled under our bankruptcy laws. Changes of the scope of what is being proposed by the NBC should not be made based solely on the information currently being reviewed.

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2. Unmentioned Statutory Variances Between Existing Small Business Chapter 11 and NBC Proposal for Chapter 12.

Again and due to time constraints, some additional variances between the current provisions governing small business Chapter 11 cases and those for Chapter 12 proposed by the NBC are discussed. Unfortunately in the short time I have had to analyze the NBC Proposal and its supporting information, I am not able to set forth all statutory alterations and their potential impact on creditors. Rather, I have selected a few of significance and attempted to avoid going over some of those mentioned in the NBC Proposal. As occurs in many statutory proposals, some of the technical details reveal changes one might not consider without consideration of these technicalities.

One is the change in adequate protection payments authorized under § 361 of the Bankruptcy Code for the impact on a creditor's interest in property of a debtor's bankruptcy estate caused by imposition of the automatic stay of § 362, the use, sale, or lease of property by a debtor under § 363 of the Bankruptcy Code, and obtaining credit by a debtor under § 364 of the Bankruptcy Code. In its essence, adequate protection is designed to protect a creditor from a decline in value of property securing repayment of a debt during the period from the filing of a bankruptcy case up to the confirmation of a plan of reorganization resulting from actions taken or not taken under 11 U.S.C. §§ 362-364. It also protects certain others from declines in value of property of the bankruptcy estate. In a Chapter 11 case, adequate protection may be paid for a decrease in the value of a creditor's interest in property or for the realization by a creditor of what is called the indubitable equivalent of the creditor's interest in property lost by actions taken or not taken under §§ 362, 363, & 364 of the Bankruptcy Code. The creditor's interest is generally the value of the secured portion of his/her/its claim against the debtor's estate.

In a Chapter 12 case, § 361 is made inapplicable by § 1205(a). In its stead, § 1205(b) allows payment of adequate protection for a decline in value, but not the same decline in value. It is for a decrease in the value of the property securing a claim or the creditor's ownership interest in the property. On a first reading these may appear to be identical in application, but they are not always so.

The difference is significant in cases where a creditor is under secured, fully secured with no equity cushion, or only marginally over secured. By way of example, a decrease in the value of a property securing a fully secured creditor's claim in a Chapter 11 that takes the value below what it was as of the bankruptcy filing date and below what was owed may be recompensed under § 361. In a Chapter 12 case, an impairment in the value of the creditor's secured claim occurring after the filing of the bankruptcy case without a concomitant decline in the value of the property does not necessarily allow for an adequate protection payment. Compare 11 U.S.C. § 361(1)-(3) with 11 U.S.C. § 1205(b)(1)-(4); see also, In re Turner, 82 B.R. 465, 469 (Bankr. W.D. Tenn. 1988), In re: Anderson, 88 B.R. 877, 890 (Bankr. N.D. Ind. 1988), Matter of Bluridg Farms, Inc., 93 B.R. 648, 656 (Bankr. S.D. Iowa 1988).

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Although when and under what circumstances adequate protection payments may be made in a Chapter 11 versus a Chapter 12 case may be somewhat difficult to comprehend for those not familiar with the process and the purpose behind making such payments, it is enough to understand that in business bankruptcy cases currently in Chapter 11 adequate protection payments may be made under circumstances that would not allow adequate protection payments to be made in a Chapter 12. For a creditor facing such a prospect, this can be a matter of some moment. This is especially critical in bankruptcy cases involving collateral that quickly declines in value.

Another posited change in the technicalities of the statute that will increase risk to creditors is when a business debtor may sell property. In Chapter 11, § 363(f) delineates only five (5) instances when property of a bankruptcy estate may be sold under § 363(b) or (c) free and clear of any interest in such property of an entity other than the estate: when applicable bankruptcy law permits such a sale; the entity with an interest in the property agrees to the sale; the sale price of the property is greater than the total value of all liens on the property; the interest of the entity is in bona fide dispute; and the entity with an interest in the property can be compelled in a legal or equitable proceeding to take a money satisfaction of the interest. Although § 1206 as it is proposed to be modified in the NBC Proposal makes § 363(f)'s sale provisions applicable to sales in a case under Chapter 12, it also incorporates the greater latitude given in Chapter 12 to family farmers and family fishermen to sell property free of interests of others, including creditors, without having to demonstrate the existence of one of the five § 363(f) requisites. An example that highlights this broader ability to sell property free and clear of interests of others is one may not be able to sell a property in a Chapter 11 if the sale price is less than the value of all liens secured by the property. "May not be able to sell" is the terminology used due to the fact that there has been disagreement among the courts regarding whether value of liens in § 363(f) is the total dollar amount of liens at face value or the aggregate value of such liens capped at the market value of the property which results in the value of all liens never being greater than the sale price of the property. In a Chapter 12, such a sale may occur without such restrictions.

Some may view this difference as insignificant, but it is not so in many cases. Where value may be stripped from a creditor or interest holder in the property sold is in the valuation process. This process is fraught with difficulties. What often occurs is valuations from the differing sides that vary widely in amount. Judges, many without training in valuation of assets, must then decide what value should be utilized. Is it the highest one, the lowest one, one somewhere in between, or none at all. Frequently, a value is set that is somewhere in the middle of the high and low value and has no basis in the evidence presented. This could result in a sale of property when one should not occur or no sale of property when a sale should occur. In either instance, value may be lost by one party with an interest in the property and gained by another. Just which party depends on whether the valuation error favored the bankruptcy estate's interest or the creditor's or another party in interest holder's interest. Although it is true that such a

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problem is less likely to occur under the NBC Proposal for Chapter 12, it is also accurate that for those instances when § 363(f) prevents a sale because the court correctly values a property that no inappropriate transfer of value from one interest holder to another will happen in a Chapter 11 case. The same may not be said in a Chapter 12 were sales may occur unfettered by the § 363(f)(3) requirement.

In another area, Chapter 11 differs from the NBC Proposal: § 1112 allows conversion or dismissal of a Chapter 11 case in instances when § 1208 does not. One such instance is that a debtor's request for a dismissal in a Chapter 11 case is not absolute whereas in Chapter 12 it is unless the case was previously converted from another chapter. Compare 11 U.S.C. § 1208(b) with 11 U.S.C. § 1112. Another is conversion from a Chapter 12 to another chapter is afforded to only a debtor unless the debtor has committed fraud in connection with his Chapter 12 case. 11 U.S.C. § 1208(a), (d). Conversely, Chapter 11 permits conversion on the request of others when it is in the best interests of the creditors and the estate. 11 U.S.C. § 1112(b)(1). These differences are very relevant to creditors and other parties in interest in a bankruptcy case. The Chapter 12 provisions effectively free a debtor from having to worry about being forced into another chapter of a bankruptcy case where he/she/it may lose control of the business estate because of his/her/its actions in the Chapter 12 case. An example is when a Chapter 12 case is not working according to a debtor's confirmed plan or when a debtor deviates from the approved Chapter 12 plan and no fraud is involved. In Chapter 12, a creditor's option is limited to dismissal of the case because conversion is not an available option.

Along with the change in how reorganization plans are reached in a Chapter 11 as distinguished from a Chapter 12 case discussed in an earlier portion of this testimony, the differences in the technical aspects of a Chapter 11 as compared to those of a Chapter 12 set forth in this part of this testimony are some of what are the increased risks to a creditor and others in a Chapter 12. Others exist which must be considered and are not in the NBC Proposal. Another is the limitations placed on the rejection of collective bargaining agreements under § 1113 of Chapter 11 does not exist in a Chapter 12 under the NBC Proposal. This would enable one in a Chapter 12 to avoid the qualifications on rejection of a collective bargaining agreement imposed in Chapter 11. Under the NBC Proposal, those potentially able to avoid § 1113's provisions would be the majority of business bankruptcy cases that would have been filed under Chapter 11. This possibly encompasses hundreds of large and very large business bankruptcy cases. The question for the Subcommittee Members is whether these sorts of changes and outcomes are ones contemplated and ones that should occur.

Still other of these technical variations between the current Chapter 11 provisions applicable to small business debtors and those suggested by the NBC for a modified Chapter 12 exist including, but not limited to, not having the § 1111(b) election in Chapter 12 and the exemption from securities laws under § 1145. Some are relatively minor in impact. Certain ones impose greater risks and costs on creditors and other parties in interest. Unfortunately, time

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precludes a longer discussion of these others. The summary of what is being testified to in this portion is that more investigation and analysis into the technical aspects is merited before enactment of changes such as those being pushed by the NBC.

3. The Elimination of the Disinterested Standard for All Professionals Employed Under Section 327.

The NBC Proposal is to eliminate the "disinterested" standard of § 327 of the Bankruptcy Code which prevents attorneys, accountants, appraisers, auctioneers, and other professional persons appointed under this section to represent or assist a debtor or trustee. This arises in many cases from the fact that an attorney, accountant and other professionals are owed money by a debtor for services provided before the bankruptcy case is filed and § 101(14) specifies that a creditor is not disinterested. The only basis given by the NBC for making the disinterested standard for employment of professionals inapplicable in a Chapter 12 case is the unsupported statement that "[i]t would be unduly burdensome to force small businesses to find new attorneys or accountants after commencing a Chapter 12 case." Nothing more is suggested in support of such an alteration of the current requirement of disinterestedness. There is no data reflecting increased financial costs or delays detrimental to the business bankruptcy case. No consideration of why the disinterested qualification was enacted for all appointments of professionals under § 327 is presented and why it should only be altered in Chapter 12 cases for family farmers, family fishermen, and small businesses as defined under the NBC Proposal while others appointed in other chapters of the Bankruptcy Code must still meet this disinterested requirement.

This omission and unsupported assertion becomes more poignant when one recognizes that many cases filed under Chapter 7 and 11 involve debtors with less resources than those under the NBC Proposal. It also overlooks that sometimes professionals waive any monies owed for pre-bankruptcy services to overcome the disinterested requirement and are allowed to be appointed as a representative of or to assist the debtor in a bankruptcy case. This NBC asserted necessary change is simply unsupported.

4. Summary and Conclusion

Given the extremely limited time within which I have had to prepare this written testimony, I have not been able to detail all of the problems, difficulties, and nuances presented by the NBC Proposal. Rather, I have attempted to highlight aspects of three categories for your consideration. One is the lack of random sampling and other data problems which demonstrate that some of the so-called "basic facts" and "fundamental flaws" in Chapter 11 are not proven by the studies relied upon by the NBC. Another is that the NBC Proposal has far greater application to business cases currently processed via Chapter 11 than is revealed in the NBC's Chapter 12 proposed amendments. The far more important aspects of just what such a change to business

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reorganizations under bankruptcy law could do from an economic point of view includes potentially (1) increasing the costs of borrowing for all business borrowers and (2) decreasing the availability of credit from what each would otherwise have been. Within the narrower categories of this testimony has been consideration of some of the more technical features of how the bankruptcy statute would be changed causing increased risks associated with bankruptcies for creditors and others without a demonstration that any benefits achieved outweigh the added risks and costs imposed.

My comments are not meant to indicate that nothing should be done to improve the bankruptcy process for truly small business entities. It is to suggest that the NBC Proposal is flawed and based on incomplete and not demonstrably accurate and verifiable data. It is to also set forth that more needs to be done before such a major change to the bankruptcy laws of this country is made of the magnitude of what is suggested.

Once more, Mr. Chairman, I thank you and the other Subcommittee Members for allowing me to present these views. As importantly, and despite any differences in views we may have, I thank each of you for your dedicated service to our country.

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Case Counts by Estimated Asset & Liability Codes

Assets \ Liabilities	A	B	C	D	E	F	G	H	I	J	7	8			Total
A	564	115	393	234	517	154	46	99	48	74	-	-	-		2,244
B	22	57	149	56	59	10	3	14	-	2	-	-	-		372
C	40	44	542	341	345	26	6	6	4	5	-	-	-		1,359
D	26	10	134	458	481	36	6	-	4	21	-	-	-		1,176
E	64	18	91	260	3,198	337	41	58	5	78	-	-	-		4,150
F	33	3	20	4	203	599	55	63	16	57	-	-	-		1,053
G	9	1	1	3	20	36	87	128	4	11	-	-	-		300
H	6	2	3	2	8	28	31	348	88	23	-	-	-		539
I	3	-	1	2	1	1	1	60	146	72	-	-	-		287
J	2	-	-	-	1	3	-	3	29	1,196	-	-	-		1,234
7	-	-	-	-	-	-	-	-	-	-	-	-	1	-	1
8	-	-	-	-	-	-	-	-	-	-	-	-	-		-
	-	-	-	-	-	-	-	-	-	-	-	-		84	84
Total	769	250	1,334	1,360	4,833	1,230	276	779	344	1,539	-	1		84	12,799

Key	
A	$0 to $50,000
B	$50,001 to $100,000
C	$100,001 to $500,000
D	$500,001 to $1,000,000
E	$1,000,001 to $10 million
F	$10,000,001 to $50 million
G	$50,000,001 to $100 million
H	$100,000,001 to $500 million
I	$500,000,001 to $1 billion
J	More than $1 billion
7	$50,000,000 < x <= $100,000,000
8	>$100,000,000
blank	Not Reported

Case Counts by Listed Dollar Values (Summary of Schedules)

		Assets			Liabilities			
		Total	Real Prop	Pers Prop	Total	Secured	Unsecured Priority	Unsecured Non-Priority
= 0		5,411	8,294	8,077	5,112	6,067	8,855	5,817
> 0	<= 100,000	807	109	2,568	243	420	2,715	1,704
> 100,000	<= 200,000	421	160	787	220	312	489	771
> 200,000	<= 300,000	296	132	473	237	238	240	508
> 300,000	<= 400,000	251	160	294	218	230	121	389
> 400,000	<= 500,000	234	155	207	239	235	68	330
> 500,000	<= 600,000	228	133	181	213	201	54	255
> 600,000	<= 700,000	181	108	141	225	176	41	212
> 700,000	<= 800,000	197	155	125	184	187	34	148
> 800,000	<= 900,000	168	138	84	180	175	16	142
> 900,000	<= 1,000,000	185	135	97	172	146	19	142
> 1,000,000	<= 1,100,000	163	100	77	157	145	8	123
> 1,100,000	<= 1,200,000	127	106	60	139	136	16	101
> 1,200,000	<= 1,300,000	147	99	67	172	136	15	98
> 1,300,000	<= 1,400,000	121	80	66	122	121	10	102
> 1,400,000	<= 1,500,000	119	106	42	123	121	7	82
> 1,500,000	<= 1,600,000	113	71	60	125	85	7	62
> 1,600,000	<= 1,700,000	102	71	45	136	108	9	57
> 1,700,000	<= 1,800,000	89	66	46	102	91	2	62
> 1,800,000	<= 1,900,000	74	67	35	118	93	3	53
> 1,900,000	<= 2,000,000	104	84	42	99	113	2	52
> 2,000,000	<= 2,100,000	85	55	23	108	88	6	47
> 2,100,000	<= 2,200,000	83	62	27	102	94	3	36
> 2,200,000	<= 2,300,000	80	37	36	96	67	2	37
> 2,300,000	<= 2,400,000	58	43	20	85	87	1	27
> 2,400,000	<= 2,500,000	65	66	28	92	54	1	26
> 2,500,000	<= 3,000,000	256	207	96	355	288	13	140
> 3,000,000	<= 3,500,000	253	196	72	269	225	5	112
> 3,500,000	<= 4,000,000	219	159	83	231	191	8	90
> 4,000,000	<= 4,500,000	189	139	63	188	168	8	75
> 4,500,000	<= 5,000,000	147	111	37	178	130	1	67
> 5,000,000	<= 5,500,000	129	77	41	151	103	-	50
> 5,500,000	<= 6,000,000	93	79	33	110	101	-	43
> 6,000,000	<= 6,500,000	85	63	39	109	82	-	33
> 6,500,000	<= 7,000,000	95	79	29	98	69	1	41
> 7,000,000	<= 7,500,000	80	45	32	74	59	1	40
> 7,500,000	<= 8,000,000	62	62	25	88	67	-	25
> 8,000,000	<= 8,500,000	52	39	23	76	54	1	23
> 8,500,000	<= 9,000,000	62	41	20	59	41	1	23
> 9,000,000	<= 9,500,000	62	35	21	57	62	1	29
> 9,500,000	<= 10,000,000	39	38	23	64	59	1	21
> 10,000,000	<= 20,000,000	538	370	176	635	449	12	182
> 20,000,000	<= 30,000,000	185	114	71	216	150	2	66
> 30,000,000	<= 40,000,000	77	53	30	134	76	1	50
> 40,000,000	<= 50,000,000	53	26	24	65	40	-	14
> 50,000,000	<= 60,000,000	37	12	19	37	20	-	15
> 60,000,000	<= 70,000,000	31	12	15	28	12	-	13
> 70,000,000	<= 80,000,000	17	8	12	65	66	-	10
> 80,000,000	<= 90,000,000	12	2	8	25	13	-	11
> 90,000,000	<= 100,000,000	10	9	6	20	7	-	12
> 100,000,000	<= 200,000,000	87	22	41	110	75	1	39
> 200,000,000	<= 300,000,000	22	3	19	52	40	-	14
> 300,000,000	<= 400,000,000	11	2	7	41	44	1	18
> 400,000,000	<= 500,000,000	9	1	10	17	12	-	4
> 500,000,000	<= 600,000,000	4	-	2	8	2	-	2
> 600,000,000	<= 700,000,000	1	-	2	3	1	-	3
> 700,000,000	<= 800,000,000	3	-	2	2	3	-	3
> 800,000,000	<= 900,000,000	-	-	-	-	19	-	-
> 900,000,000	<= 1,000,000,000	2	1	1	-	-	-	-
> 1,000,000,000	<= 2,000,000,000	7	2	5	157	129	1	34
> 2,000,000,000	<= 3,000,000,000	1	-	1	18	5	-	8
> 3,000,000,000	<= 4,000,000,000	-	-	1	4	-	-	4
> 4,000,000,000	<= 5,000,000,000	2	-	1	3	1	-	2
> 5,000,000,000	<= 6,000,000,000	-	-	-	1	-	-	-
> 6,000,000,000	<= 7,000,000,000	-	-	-	-	9	-	-
> 7,000,000,000	<= 8,000,000,000	-	-	-	-	1	-	-
> 8,000,000,000	<= 9,000,000,000	-	-	-	-	-	-	-
> 9,000,000,000	<= 10,000,000,000	-	-	-	9	-	-	-
> 10,000,000,000	<= 20,000,000,000	-	-	-	1	-	-	-
> 20,000,000,000	<= 30,000,000,000	-	-	-	-	-	-	-
> 30,000,000,000	<= 40,000,000,000	-	-	-	-	-	-	-
> 40,000,000,000	<= 50,000,000,000	-	-	-	-	-	-	-
> 50,000,000,000	<= 60,000,000,000	-	-	-	-	-	-	-
> 60,000,000,000	<= 70,000,000,000	-	-	-	-	-	-	-
> 70,000,000,000	<= 80,000,000,000	-	-	-	-	-	-	-
> 80,000,000,000	<= 90,000,000,000	-	-	-	-	-	-	-
> 90,000,000,000	<= 100,000,000,000	-	-	-	-	-	-	-
> 100,000,000,000		1	-	1	-	-	-	-

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Supplemental Testimony of

Hon. Thomas B. Bennett
United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Alabama
Birmingham, Alabama

before
Senate Committee on the Judiciary, Subcommittee on Administrative Oversight of the Courts

"Could Bankruptcy Reform Help Preserve Small Business Jobs?"

March 23, 2010

Subcommittee Chairman Whitehouse, Ranking Member Sessions, and Members of the Subcommittee, I am submitting supplemental written testimony pursuant to the request of Chairman Whitehouse and Ranking Member Sessions made at the conclusion of the March 17, 2010 hearing. Again, what is set forth in this supplemental testimony constitutes my views, not those suggested to me by others. Additionally, I make these supplemental remarks in my individual capacity and not as a representative, member or officer of any group or organization.

Due to time limitations during the March 17, 2010 hearing, a couple of my remarks follow on some of what was testified to during the hearing. The residual deal with matters which I believe the Subcommittee should consider in the context of whether and how changes may be made to the Bankruptcy Code, 11 U.S.C. §§ 101 et seq. (Bankruptcy Code), for purposes of facilitating successful reorganizations of small business bankruptcies.

1. Not Revenue Neutral, Feasibility a/k/a The Plan Works Analysis Mandated in Both Chapter 11 and Chapter 12, Cash Flow is the Issue Whether Called Administrative Priority Expense or Otherwise, and Business Acumen, Not Legal, is What Counts.

A. Likely Loss of Government Revenues.

During the March 17th hearing, the belief was expressed that amending the Bankruptcy Code to enable certain small businesses to reorganize under Chapter 12, instead of the currently applicable Chapter 11, would be revenue neutral as it regards the United States. However, this would not be the case. In reality, it would cause a loss of revenues to the United States and for the funding mechanism for the two groups given significant responsibilities under the

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Bankruptcy Code: the United States Trustee Program (U.S. Trustee) and the Bankruptcy Administrator Program (Bankruptcy Administrator). This is due to funding of each by quarterly fees imposed in Chapter 11 cases. The fee is a minimum quarterly amount of $325.00 for disbursements in a quarter of less than $15,000.00 and increases based on quarterly disbursements by a Chapter 11 debtor until it reaches $30,000.00 for any quarter in which disbursements exceed $30,000,000.00. See 28 U.S.C. § 1930(a)(6)-(7). These fees are paid from the filing of a debtor's Chapter 11 case until the case is either converted or dismissed. For the six (6) bankruptcy court districts with a Bankruptcy Administrator , the fees received for fiscal year 2009 were approximately $2,400,000.00. As of the time of submission of this supplemental testimony, I have obtained the amount of these fees received for the eighty-four (84) bankruptcy court districts with a U. S. Trustee for fiscal year 2009. It was just over $118,500,000.00. Furthermore, the budget information set forth on the U.S. Trustee Program's website for fiscal year 2010 estimates revenues of about $136,000,000.00 and for fiscal year 2011 at slightly over $148,600,000.00.

Unlike Chapter 11, there is no fee paid to either the U.S. Trustee or to the Bankruptcy Administrator for cases filed under Chapter 12. To the extent that a significant number of cases now filed under Chapter 11 will elect to file under the National Bankruptcy Conference Proposal's (NBC Proposal) Chapter 12 , multiple millions of dollars in federal revenues received by the United States of Department of Justice for the U.S. Trustee and by the United States Courts for the Bankruptcy Administrator will be lost. Thus, any view that the proposed National Bankruptcy Conference (NBC) propounded amendments to Chapter 12 would be revenue neutral is inaccurate. What the result would be is be less revenue for the United States before taking into account the negative revenue effect arising from the Chapter 12 case filing fee being $800.00 less than that for a Chapter 11 case.

B. Feasibility By Another Name is Still Feasibility a/k/a The Plan is Likely to Work.

There has been a the contention by some that Chapter 12 looks at what is termed "feasibility" when confirming a plan and that, in contrast, this is not one of the factors reviewed before confirmation of a Chapter 11 plan. Feasibility is a term used to reference whether the requirement for confirmation of a Chapter 12 plan in 11 U.S.C. § 1225(a)(6) and an identical prerequisite of confirmation for a Chapter 13 plan in 11 U.S.C. § 1325(a)(6) have been met. Each imposes on the confirming court that it determine that "the debtor will be able to make all payments under the plan and to comply with the plan." Essentially, this means that the debtor will be able to perform the terms of the confirmed plan including, but not limited to, making all payments to creditors as and when specified in the plan. More simply, it is a determination that the plan is likely to work.

Although this "feasibility" language used by bankruptcy professionals in the context of confirmation of Chapter 12 and 13 plans does not appear in verbatim format in the confirmation section of Chapter 11, 11 U.S.C. § 1129, the feasibility concept is part of what is considered by all bankruptcy courts when confirming a plan of reorganization. The terminology is "[c]onfirmation of the plan is not likely to be followed by liquidation, or the need for further

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financial reorganization, of the debtor or any successor of the debtor under the plan..." 11 U.S.C. § 1129(a)(11). Confirmation of a Chapter 11 plan has as a requisite that one being reorganized be able to perform under the plan so that liquidation or further reorganization will not likely occur. This is the import of § 1129(a)(11) even if the language is different from that used in §§ 1226(a)(6) and 1325(a)(6). Just as used when dealing with the similar provisions for Chapters 12 and 13, it is simply a long form of analyzing whether a plan of reorganization is likely to work.

So, the contention that Chapter 12 is a better avenue for reorganization for small businesses because "feasibility" is considered as part of the confirmation process for cases under Chapter 12 when it is not in Chapter 11 is unsupported. This arises from the fact that the same basic analysis is necessary under Chapter 11 of the Bankruptcy Code: whether the plan is likely to work.

C. Administrative Expenses, Utility Adequate Assurances and the Reality that What Counts is the Timing and Amount of these Payments Relative to Cash Flow.

(I) Dollar Amounts Not Necessarily Less.

Not having cash or the ability to obtain cash to pay a debtor's post bankruptcy ongoing obligations is a feature shared by most, if not all, bankruptcy reorganizations that fail. Some of the more astute debtors know that insolvency is likely to happen a long time before it occurs and plan in advance on how to meet the obligations requiring payment on a day to day basis during a bankruptcy case. If possible, they avoid complete depletion of cash and sources of cash. Likewise, they try not to fully collateralize debts with all assets. Conversely, the less fortunate or less astute begin the bankruptcy process having little or no cash and, at the same time, no or a very limited, ability to obtain cash because asset values have been fully utilized to secure debt. Since a large number of bankruptcy cases begin with debtors having little or no cash available to pay ongoing obligations and limited, if any, ability to borrow, paying day to day operating expenses is a major problem for this category of reorganization debtors. This is also a major reason why the majority of all reorganizations are unsuccessful.

So, the timing of revenues received and when and on what they are spent is critical to the successful reorganization of a business debtor's financial affairs. In fact, it is true of all debtors attempting to reorganize her/his/its financial affairs via the bankruptcy process.

The NBC Proposal for Chapter 12 to expanded its reach to include small business entities contains as one of its "fundamental flaws" of Chapter 11 for small businesses what it denominates as "Obstacles to Reorganization: Chapter 11 includes a set of procedures (due in part to the reforms of 2005) that create serious roadblocks to reorganization." The NBC's contention is that BAPCPA's change in the deposit requirements for utilities under § 366 of the Bankruptcy Code and what are called in bankruptcy jargon § 503(b)(9) claims – those which are

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awarded an administrative priority claim status for goods received by a debtor within 20 days before a bankruptcy filing – coupled with lower administrative priority claims caused by the simplification and quickness of the bankruptcy reorganization process in Chapter 12 reduce the so-called Obstacles to Reorganization of Chapter 11. Perhaps the single most important aspect of this reduction in obstacles is that Chapter 12 allows payment of administrative priority claims over time compared to the Chapter 11 mandate of relative immediate payment on confirmation unless administrative priority claim holders otherwise agree. Compare 11 U.S.C. §§ 1129(a)(9)(A) with 11 U.S.C. § 1222(a)(2), 1225(a)(1).

One point I wish to make is that the extent to which, if at all, the § 366 utility adequate assurance of payment, § 503(b)(9) administrative expenses, professional and related costs of reorganization, and the pay over time Chapter 12 payment of administrative expenses have significance varies by case. It is also that they may not matter in some cases along with the fact that payment via a Chapter 12 case may cause reorganization to fail when it might have succeeded in a Chapter 11 case. Why these are so in a given case needs amplification.

If one looks at what are the administrative expense categories under § 503 of the Bankruptcy Code, a number of administrative expenses will be the same in a Chapter 12 as in a Chapter 11. These may include, but not exclusively, wages and salaries, lease payments, taxes, and other costs and expenses incurred in connection with preserving a debtor's business. With the exception of the types of expenses incurred solely as the result of a bankruptcy case having been filed such as additional lawyer, accountant, and other professional fees and costs, all of the other categories of administrative expenses should be expected to be virtually identical in kind and amount in a Chapter 12 as in Chapter 11. This means that what I will call Bankruptcy Generated Expenses must be where the savings are to be achieved in order for a Chapter 12 debtor to have lower total cash demands than a Chapter 11 one might have.

In any given case, the § 366 utility adequate assurance requirement may vary from being negligible to large. For businesses in the extractive category, coal mining for example, and in the heavy industry category, making steel or aluminum, utility bills and as a result demands for adequate assurance may be in the hundreds of thousands of dollars and more. For other businesses such as some of those in the service sector, utility expenses and, as an outcome, adequate assurance may be very small. The same range of § 503(b)(9) administrative expense payments exists. Those with little or no need for "goods" that might have been received within 20 days of filing a bankruptcy by a debtor, a law firm, accounting firm, employment agency to name a few, will have relatively little or no administrative expenses in this category. Those in the retail sales businesses would be expected to have larger and possibly very large § 503(b)(9) administrative expense claims. However, nothing in Chapter 12 makes the dollar amount of § 336 utility adequate assurance or of § 503(b)(9) claims different from the amount they would be in Chapter 11. The important aspect is that of the Bankruptcy Generated Expenses caused by

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§ 503(b)(9) and § 366 requirements, they is no different in Chapter 11 than in Chapter 12. The unassailable consequence is that the dollar amounts of these are equal obstacles in both chapters.

The same is true in Chapter 12 for the timing of the provision for, or payment of, adequate assurance for utilities. The time periods are identical for both chapters of the Bankruptcy Code. See 11 U.S.C. § 366. Unless one alters § 366 to afford Chapter 12 debtors more lenient treatment when it comes to adequate assurance protection for utilities, this means the utility adequate assurance imposition on a debtor based on when it must take place cannot be any more of an obstacle to reorganization in Chapter 11 than in Chapter 12. Conversely and for payment of § 503(b)(9) claims, there remains a difference under the statute which is the timing of payment of these claims. A debtor in Chapter 12 has the ability without agreement of administrative priority expense creditors to spread payment of these expenses over time following confirmation of a plan which he/she/it may not do in a Chapter 11 without creditor agreement. A little more discussion of the amount of Bankruptcy Generated Expenses is warranted before looking more closely at the timing of payment of administrative priority expenses.

What is left of the Bankruptcy Generated Expenses is principally the lawyer, accounting and other professional fees and costs caused by the reorganization process. To have a successful reorganization, the financial and business plan development, which should not be confused with the drafting of the plan documents, of a given debtor should involve about if not the same costs in a Chapter 11 and 12. This is due to the fact that the same business and financial analysis should be done for a given debtor in either context to have a successful reorganization. Of course, this assumes that one does not view Chapter 12 as a mechanism to avoid or minimize such critical financial and business analysis and structuring. If this were the case, I suggest that Chapter 12 would be counter productive to the success of any small business reorganization.

Likewise, many of the other categories of Bankruptcy Generated Expenses that fall into the professional fees and costs categories would be expected to be the same in both chapters. Some in this category are costs caused by objections to claims, valuation of assorted properties, and adversary proceeding litigation. Others that may be greater in a Chapter 11 case are those associated with rejection of collective bargaining contracts, voting, classification of claims treatments which are essentially those incurred by the more detailed technical legal requirements of what is included in a Chapter 11 plan and its confirmation which are not necessitated in Chapter 12. In some instances, these will be small in difference between those incurred in a Chapter 12 versus a Chapter 11. In others, especially the larger and more complex cases, they will be greater in Chapter 11. In yet others, they may be the same regardless of the chapter utilized for reorganization. The NBC is correct that a savings is potentially achievable in some Bankruptcy Generated Expenses in some bankruptcies when one files a case under the NBC Proposal for Chapter 12 compared to Chapter 11. As importantly, there will not be such savings in all cases.

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This is only part of the picture of the size of Bankruptcy Generated Expenses. Chapter 11 has an associated expense of U.S. Trustee or Bankruptcy Administrator fees not imposed on a Chapter 12 debtor. See 28 U.S.C. § 1930(a)(6)-(7). On the other hand, Chapter 12 has another type of fee paid to the trustee of a Chapter 12 case. See 11 U.S.C. §§ 326(b), 1226(a)(2). In some cases, the fees paid to a Chapter 12 trustee may exceed those paid to the U.S. Trustee or Bankruptcy Administrator in a Chapter 11 case. In others, the reverse may be what happens. As a consequence, Chapter 12 is not necessarily the least expensive when it comes to trustee types of fees. It depends on the percentages/amounts of such fees and the amounts of monies disbursed or received under the applicable standard for determining such fees.

(II) Timing in the Eyes of a Debtor: Faster is Not Always Better.

The remaining significant point in the NBC Proposal for why the Obstacles to Reorganization are less in Chapter 12 is that one has the ability without creditor agreement to pay administrative priority expenses over time following plan confirmation when one may not do likewise without creditor agreement in a Chapter 11. It is asserted that this makes reorganization under Chapter 12 more likely to be succsssful. As with some of the items of expenses associated with bankruptcy which do not differ in amount between Chapters 11 and 12 and those not necessarily less in a Chapter 12 than in Chapter 11, the ability to pay administrative expenses over time is not, in all instances, a benefit. It will in some instances be a detriment when one understands how creditors are supposed to be paid under a plan.

Why this is so arises from the costs to a debtor associated with a delay in payment of other creditors necessarily arising from deferring payment of administrative priority expenses over some time period following confirmation of one's plan. For example, any delay in payment of an allowed secured or an allowed unsecured claim will in certain instances result in an increase in what is required to be paid to a creditor(s) holding such a claim(s) over what it would otherwise have been. The increase from delaying payment to these categories of secured and unsecured claims is, in some Chapter 12 cases, but not all, required by what is in reality a present value equivalence imposed by 11 U.S.C. § 1225(a)(4), (a)(5)(B)(ii), and (b)(1)(A). To the extent that these allowed secured or allowed unsecured claims are large enough in dollar amount and/or the discount or interest rate factor is high enough, the increase in total payments over time incurred by paying administrative priority expenses in a deferred fashion may during the debtor's repayment period actually increase the aggregate cash flow demands on a debtor over those of one under Chapter 11.

All of this potential for increases in cost and aggregate cash flow requirements for some Chapter 12 debtors coming from a delay in payment of administrative priority expenses is complex due to both the technical legal requirements and the present value equivalent determinations. Fortunately, an easier description is that what can occur is that the impacted secured and unsecured creditors are making a forced loan to a debtor for which in some, but not all, cases the Chapter 12 debtor will be required to pay them added monies for the further stretching out of payments to them under the Chapter 12 plan than may have otherwise been the

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case. This delay in paying administrative priority expenses extends out repayment of some claims because it will ordinarily cause a lowering of monthly, quarterly, semi-annual or annual payments from what might have been paid on, for instance, a secured claim so that the increased interest over the longer payback period exceeds the aggregate of what the cash demands would have otherwise been. All of this arising from a delay in payment of administrative priority expenses for want of having sufficient cash flow at confirmation of a plan under Chapter 12. In fairness to the NBC's position, the ability to defer payment on administrative priority expenses should in almost all instances reduce the initial cash flow requirements, but for some this initial deferment may be at the expense of longer term survival of the business. Fortunately, this sort of increased cost and aggregate cash flow requirements is not often seen or recognized in reorganization cases.

Once again, it is not a universal fact that Chapter 12 always avoids what the NBC defines as Obstacles to Reorganization. Sometimes the dollar amounts are the same or less in a Chapter 12 case than in Chapter 11 when it comes to administrative priority expenses. They should never differ when it comes to § 366 utility adequate assurances and in dollar amount the administrative priority expenses may be less in some Chapter 11 cases than in a Chapter 12. At the same time, the cash flow demands of paying administrative priority expenses over time may actually be greater in aggregate amount over the relevant time period in some Chapter 12 reorganizations.

What must be coupled with this factor is that what happens in a Chapter 12 case is a relatively quicker disbursement from a debtor to a trustee from what may be a restricted cash availability. When compared with the bankruptcy statute's longer breathing room to accumulate cash and obtain higher cash flow levels to assist in repayment of administrative priority expense claims that is implicit in the longer time given to develop a Chapter 11 plan and have it implemented, Chapter 12 presents a greater cash flow obstacle to reorganization for some debtors than that faced under Chapter 11. The summary is that the Chapter 12 template is not the panacea for all small businesses because for some the NBC's argued "fundamental flaws" of delay, high costs and obstacles to reorganization are flaws of Chapter 12 for some small business debtors when they are not under Chapter 11.

D. Trustees and Business versus Legal Acumen.

Some of the testimony has been to the effect that a Chapter 12 trustee possesses the capabilities to provide continuous and unbiased information about a debtor's viability including oversight of business operations. While it is accurate that Chapter 12 trustees have and continue to provide information regarding a debtor's operations, the focus of virtually all of what a Chapter 12 trustee does is in the framework of whether the debtor has and continues to comply with what is required of her/him/it under the legal requirements of Chapter 12. These involve checking on receipts and disbursements made by a debtor, payment of post petition obligations by a debtor, submitting the requisite documents and plans to the court, valuation of properties, and seeing that a debtor is performing the other bankruptcy law obligations.

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These sorts of duties are distinctly different from knowing and giving business plan and financial plan advice and being able to assess from a business perspective whether what is proposed for the day-to-day operations of any business will assist it in achieving its reorganization goal. As a general matter, trustees do not advise on hiring and firing of employees, advertising, sales goals, from whom to purchase inventory and supplies, how to expand sales territories and a plethora of similar day to day and long term activities of a business. These are precisely the types of business information and direction that many small businesses lack and need.

Why almost all Chapter 12 trustees lack the ability to provide this sort of counseling is that the overwhelming majority of trustees in bankruptcy cases are lawyers without the magnitude and level of business education and experience to be able to properly give advice in most business arenas. In reality, most lawyers have no educational background in business subjects and their business experience is limited to that obtained in the practice of law if he or she actually was involved in the operation of a law practice. This is not the business acumen called for by most businesses hoping to successfully reorganize. A trustee's performance of Chapter 12 duties is not a substitute for the business expertise needs of most small businesses. Once more, this assumes that Chapter 12 will not be utilized as a method of avoiding what should be done to successfully reorganize a business.

It is this business expertise required by many small businesses which will be caused to be absent in a Chapter 12 redesigned under the NBC Proposal. This arises in large part by the structural difference between the plan process in Chapter 12 versus that in Chapter 11, that is, the non-consensual Chapter 12 one versus the Chapter 11 consensual conceptualization. It is also the outcome of believing that a Chapter 12 trustee is a substitute for one with business expertise. Implementing such a view toward necessary business expertise has and will inevitably lead to the failure of reorganizations.

2. Considerations for Small Business Modifications.

A. Definition of a Small Business Should Not Include Large or Complex Businesses.

As is clear from my March 17, 2010 testimony, both oral and written, the NBC Proposal is premised on a definition of a small business that includes within its scope businesses with tens of millions of dollars to billions of dollars in assets. For this reason, the simple rubric of allowing one with $10,000,000.00 or less in aggregate debt to be able to file under the NBC Proposal for Chapter 12 is too broad in reach. As the Cover Sheet Summary and the Summary of Schedules Summary data submitted with my March 17, 2010 written testimony indicate, the current definition of a small business entity offered by the NBC brings within its definition hundreds to thousands of entities that are not small businesses by anyone's reasonable definition of what a small business truly is. For this reason, a better demarcation between small businesses and others must be found.

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Even though using aggregate debt may be an easy method to identify a small business, its use without other gauges will always enable numerous non-small businesses with little or no debt to be placed in the small business category. A review of what is used by others in a non-bankruptcy setting such as by the United States Small Business Administration, securities laws, and business publications reveals a wide disparity in what is called a small business. There is, however, a common definition creating methodology. It is that each looks at more than one factor. The factors considered usually encompass more than one of debt, assets, annual revenues, and number of employees.

In the realm of bankruptcy reorganizations and should Congress want to increase the small business total debt level from where it is now, approximately $2,200,000.00, to a larger sum, the inclusion of an additional factor to demarcate between a small business and larger ones will assist in limiting the number of businesses that are not truly small from being within the scope of any small business classification. Two of the more easily used factors are annual revenues and number of employees. Adding a limit on annual revenues and/or the number of employees will help to achieve a truly small business class for reorganization purposes. This is because larger annual revenues and a greater number of employees indirectly approximates what is not a small business in terms of size and/or complexity. It suffices for now that an additional factor or factors should be employed to limit any small business provisions to only small businesses.

B. Favored Consensual Structure of Chapter 11 Need Not Be Abandoned.

One of the more costly and time consuming aspect of the current provisions governing reorganizations under Chapter 11 for all sizes of businesses are those governing disclosure statements and plans of reorganization. One vehicle to lessen both is the NBC Proposal's adoption of the Chapter 12 plan structure. Partially, its structure is the impact from having been modeled on what was originally designed for non-business individual debtors, that is individuals in Chapter 13 that rarely have the complexities of a business case. The rest comes from what is the most significant structural difference between Chapter 12 and Chapter 11.

In its essential form, a Chapter 12 plan is non-consensual. This means that, among other factors, no creditor agreement to a plan is needed to have it confirmed. It also does not allow a creditor to propose a plan. So long as a debtor includes in a plan the when and the amount of how creditors are to be paid which comports with the amounts and time period of Chapter 12's requirements, a plan is potentially confirmable. This enables a debtor to continue to utilize the collateral/monies of a creditor without having his/her/its consent. All that a creditor may do in a Chapter 12 case to avoid a confirmation that harms his interests is object to what is in a plan based on its not complying with the requirements of Chapter 12.

Contradistinguished to Chapter 12, Chapter 11 favors, if possible, achieving a degree of creditor support for reorganization. For a consensual plan, this is set by the acceptance standard of 11 U.S.C. § 1126 (c) & (d) of at least two-thirds (2/3) in dollar amount and more than fifty

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(50%) percent in the number of claims/interests in each impaired class agreeing to the terms of a plan. This acceptance standard may be avoided by having no class of creditors being impaired – they are deemed to accept the plan under 11 U.S.C. § 1126(f) – which infrequently occurs or by using the cram down provision of Chapter 11 which still requires that at least one non-insider class of impaired claims vote in favor of a plan so long as unfair discrimination is avoided and fair and equitable treatment is accorded impaired claims and interests. See 11 U.S.C. § 1129(a)(10), (b).

Ways exist to retain the favored consensual nature of plans of reorganization of Chapter 11 for small businesses while reducing the costs, time, and complexities involved. Only a few will be suggested at this juncture in the process of the Subcommittee's deliberations. This arises from the fact that it is difficult to propose modifications until one knows the scope of what may be a small business under a revised definition. A few that could be altered are the dollar amount of claims of a class accepting a plan and/or the percentage of number of claims in a class. Each could be lowered making confirmation easier, yet still founded on the favored consensual standard. In fact, one could be retained at a lower amount, e.g., less than two-thirds in dollar amount or only ifty (50%) percent in number, while the other is eliminated. A change of this sort would retain to a degree the favored consensual nature of a reorganization plan and allow creditor input into the plan adoption process that may be avoided in a Chapter 12 context. Other current aspects of what Chapter 11 necessitates for a small business are capable of easing or elimination.

It is the complexities of what is desired to occur for all small businesses that makes further recommendations problematic. Does Congress want to eliminate the retiree benefit payment provision for confirmation of 11 U.S.C. § 1129(a)(13) or the rejection of collective bargaining agreement requirements of 11 U.S.C. § 1113 for small business cases? Allowing small businesses to reorganize under Chapter 12 will have this effect, but Chapter 11 will not unless these are also eased or eliminated for small business Chapter 11 cases. To the extent that these and other of the currently applicable statutory conditions for reorganization under Chapter 11 are deemed unnecessary or unwanted by Congress, additional simplification of what Chapter 11 now requires is achievable. That which is determined to be unnecessary or unwanted controls much of what further simplification may be made to Chapter 11 for small business cases.

In the event that new small business standards are set that ease what is currently required to confirm a plan and despite what chapter may be the vehicle for such changes, one category of what is necessary that should not be eliminated is having business and financial plans prepared by those with the requisite degree of business experience and expertise. These are absent or deficient in both Chapter 12 cases and small business Chapter 11 cases to an extent that should now exist. More meaningful and detailed business and financial planning needs to exist for many small businesses undergoing reorganization whether they be farmers, fishermen, or the residual of what comprises a small business.

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C. Intuition may be Incorrect and Good Data Needs to be Obtained.

A component of the NBC Proposal is raising the total liability amount from its current level of approximately $2,200,000.00 to $10,000,000.00 on the premise that this sum better reflects what is a small business for bankruptcy reorganization purposes. At this juncture and based on more information obtained from the Administrative Office of the United States Courts since the March 17, 2010 hearing which demonstrate that the reliability of the data regarding small businesses is more questionable, caution in what is being proposed is even more important.

Regardless of the dollar amount ultimately fixed, a warning from my earlier testimony needs repetition. It is that the data from the Summary of Schedules Summary and the Cover Sheet Summary are not verified for debtor accuracy and evidence some problems exist with setting what is in or out of a small business classification based on current information. Also and by repetition, this data is used because it is a lot of what was the critical data employed in development of the NBC Proposal.

From the Summary of Schedules Summary, 8,746 out of a total of 12,799 Chapter 11 cases for 2009 had total liabilities of $2,200,000.00 or less. This is 68.33% of all Chapter 11 cases filed in 2009. For those with greater than $2,200,000.00 in total liabilities, there were 4,053 cases or 31.67% of Chapter 11 case filed in 2009 disclosing this information. If one excludes the 5,112 cases that reported both zero assets and zero liabilities on the summary of schedules, the data indicates that 3,634 Chapter 11 cases had $2,200,00000 or less in total liabilities which constitutes 47.275% of the adjusted total of 7,687 cases and 4,053 cases reported liabilities of over $2,200,000.00 or 52.725%. The $2,200,000.00 or less total liability cut off was selected because it approximates the small business total liability limitation for Chapter 11 cases in 2009.

A review of the Cover Sheet Summary reveals that a similar break point for data at the $2,200,000.00 amount is not captured by Official Form 1. Regardless of this fact, some relevant information may still be ascertained. Of the 12,799 Chapter 11 cases filed in 2009 with Official Form 1 completed, 3,713 or 29.01% had total liabilities of $1,000,000.00 or less. For the range of zero to $10,000,000.00 in total liabilities, there were 8,546 Chapter 11 cases or 66.771%. For cases with over $1,000,000.00 to and including $10,000,000.00 in both total assets and total liabilities, the number of 2009 Chapter 11 cases was 3,198 or 24.986%. This category represents the single largest grouping of cases with assets and liabilities within the same dollar range on Official Form 1.

What the Summary of Schedules Summary indicates is that from over 47% to up to approximately 68% of Chapter 11 cases filed in 2009 disclosed $2,200,000.00 or less in total liabilities and qualified for small business treatment. Although not as useful, the Cover Sheet Summary lets one know that over 30%, but less than 67% of Chapter 11 cases filed in 2009 had set forth $2,200,000.00 or less in total liabilities and would have been able to go forward under the small business provisions of Chapter 11.

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The additional data I have obtained is a summary of Chapter 11 cases started in 2009 and whether the initial documents filed showed whether a Chapter 11 debtor was a small business. It is page 14 to this supplemental testimony and is captioned Small Business Designation (Small Business Designation). This Small Business Designation demonstrates that there were actually a total of 15,189 Chapter 11 bankruptcy cases filed in calendar year 2009. Only 3,212 debtors disclosed its/her/his small business status. This is 21.1% of total Chapter 11 filings in 2009. Whether this number and percentage of small business cases is more or less accurate than that from the Summary of Schedules Summary or the Cover Sheet Summary is not known. It is most likely too low due to the fact that 1,521 filings left this disclosure blank and it is unlikely that all were not small business filings. This disparity from the Summary of Schedules Summary and the Cover Sheet Summary is both unfortunate for analytical purposes and is a state of affairs that should not and need not exist.

All that may be learned is that no less than 21.1% of the total of all Chapter 11 cases filed in 2009 were classified as a small business by the debtors and the actual number and percentage may be much greater. To ascertain just what debt level with or without another factor should be used to sort the real small businesses from the larger or more complex ones, reliable data is necessary to a greater degree to make certain that decisions are made on facts, not intuition.

All that has been set forth regarding data deficiencies illustrates problems with current data that should be more closely scrutinized. To not do so could lead to enactment of legislation ill designed to achieve the goals sought. This inconsistent data on small businesses also demonstrates why a proper design of what information should be obtained and how to retrieve it ought to have occurred years ago. Why it must be done is to insure that intuition and incomplete or misleading use of data are not the foundations for what are proposed major changes in the structure of how most businesses reorganize in the United States. Why this must be the case for how bankruptcy law changes are made is that reliable data evidences that what is intuited from incomplete information is often wrong and what is counter-intuitive is the correct state of affairs.

3. Conclusion.

Chapter 11's favored consensual plan of reorganization need not be abandoned in favor of non-consensual plans under Chapter 12. Rather, further easing of existing requirements of Chapter 11 for small businesses can achieve many, if not most, of what is sought under the NBC Proposal without fundamentally altering the dynamics of what is expected to happen for businesses reorganizing in bankruptcy. This may be achieved with a smaller impact on those who participate in the bankruptcy process by a better definition of what constitutes a small business entity to insure that large businesses or those with complex operations are not within any small business classification. Caution needs to be a guiding principle when considering expanding Chapter 12's reorganization format because there is a fundamental difference between these Chapters and the debtor-creditor positions on numerous issues of moment to both.

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Some perceive that my testimony indicates I am not sympathetic to a redoing of the bankruptcy laws for truly small, non-complex businesses. This view is incorrect. Rather, what I believe needs to occur is a better defining of "small business" so that a better and more successful template may be developed in a setting where one may more readily and accurately know what other alterations are needed and workable for such "small business" entities.

Despite giving only a limited number of suggestions to facilitate greater success in the reorganization of small businesses, I am willing to offer others and to work with all interested parties for improving the process once a clearer determination of what constitutes a small business is made. As indicated earlier and until a more limiting definition is invoked, other suggestions are, at best, speculative on their necessity and impact on parties to a business bankruptcy reorganization case.

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Small Business Designation
Chapter 11 Business Cases Filed During Calendar Year 2009

District	Total	Blank	No	Yes	Percentage Small Business
DC	50	6	37	7	14.0%
ME	53	3	33	17	32.1%
MA	230	34	133	63	27.4%
NH	57	6	43	8	14.0%
RI	20	1	12	7	35.0%
PR	158	9	78	71	44.9%
CT	139	17	71	51	36.7%
NY,N	54	2	34	18	33.3%
NY,E	264	27	154	83	31.4%
NY,S	1,709	26	1,595	88	5.1%
NY,W	55	1	23	31	56.4%
VT	3		2	1	33.3%
DE	1,481	17	1,452	12	0.8%
NJ	428	51	262	115	26.9%
PA,E	151	9	93	49	32.5%
PA,M	49	3	20	26	53.1%
PA,W	181	15	90	76	42.0%
VI	4		2	2	50.0%
MD	280	74	151	55	19.6%
NC,E	154	18	100	36	23.4%
NC,M	34		25	9	26.5%
NC,W	99	15	57	27	27.3%
SC	112	26	56	30	26.8%
VA,E	247	35	144	68	27.5%
VA,W	38	2	23	13	34.2%
WV,N	16		10	6	37.5%
WV,S	25	3	11	11	44.0%
LA,E	53	2	33	18	34.0%
LA,M	24	1	14	9	37.5%
LA,W	71	3	29	39	54.9%
MS,N	30	1	23	6	20.0%
MS,S	37	3	26	8	21.6%
TX,N	450	5	360	85	18.9%
TX,E	99	10	63	26	26.3%
TX,S	370	17	208	145	39.2%
TX,W	327	12	264	51	15.6%
KY,E	43	5	28	10	23.3%
KY,W	58	1	31	26	44.8%
MI,E	193	12	104	77	39.9%
MI,W	66	5	38	23	34.8%
OH,N	142	7	108	27	19.0%
OH,S	99	4	62	33	33.3%
TN,E	97	8	47	42	43.3%
TN,M	214	56	100	58	27.1%
TN,W	78	10	34	34	43.6%
IL,N	384	38	267	79	20.6%
IL,C	30	1	17	12	40.0%
IL,S	30	1	9	20	66.7%
IN,N	64	2	48	14	21.9%
IN,S	100	8	62	30	30.0%
WI,E	81	1	49	31	38.3%
WI,W	44	3	26	15	34.1%
AR,E	42	3	18	21	50.0%
AR,W	54	5	23	26	48.1%
IA,N	9	1	8	-	0.0%
IA,S	12	-	5	7	58.3%
MN	96	8	68	20	20.8%
MO,E	40	2	29	9	22.5%
MO,W	76	7	56	13	17.1%
NE	41	4	22	15	36.6%
ND	6	1	-	5	83.3%
SD	15	1	12	2	13.3%
AK	21	1	10	10	47.6%
AZ	613	102	375	136	22.2%
CA,N	379	123	196	60	15.8%
CA,E	226	43	115	68	30.1%
CA,C	1,126	206	784	136	12.1%
CA,S	115	28	71	16	13.9%
HI	18	1	10	7	38.9%
ID	51	7	32	12	23.5%
MT	32	3	25	4	12.5%
NV	445	88	301	56	12.6%
OR	59	10	41	8	13.6%
WA,E	50	3	38	9	18.0%
WA,W	205	34	111	60	29.3%
GU	2	-	2	-	0.0%
CO	187	8	124	55	29.4%
KS	87	4	53	30	34.5%
NM	49	8	19	22	44.9%
OK,N	10	-	9	1	10.0%
OK,E	6	-	5	1	16.7%
OK,W	51	5	34	12	23.5%
UT	91	7	62	22	24.2%
WY	19	2	12	5	26.3%
AL,N	120	10	84	26	21.7%
AL,M	37	2	16	19	51.4%
AL,S	64	6	46	12	18.8%
FL,N	34	3	22	9	26.5%
FL,M	644	98	382	164	25.5%
FL,S	284	22	203	59	20.8%
GA,N	371	42	186	143	38.5%
GA,M	52	2	34	16	30.8%
GA,S	75	5	52	18	24.0%
Totals	15,189	1,521	10,456	3,212	21.1%

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PREPARED STATEMENT OF

CHARLES D. BULLOCK

STEVENSON & BULLOCK, P.L.C.

BEFORE

UNITED STATES SENATE JUDICIARY SUBCOMMITTEE ON
ADMINISTRATIVE OVERSIGHT AND THE COURTS

"COULD BANKRUPTCY REFORM HELP PRESERVE SMALL BUSINESS JOBS?"

MARCH 17, 2010

Charles D. Bullock
Stevenson & Bullock, P.L.C.
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Mr. Chairman and Members of the United States Senate Judiciary Subcommittee on Administrative Oversight and the Courts:

My name is Charles D. Bullock. I am a practicing attorney and a founder of the Michigan based law firm Stevenson & Bullock, P.L.C. I am licensed in both Michigan and Tennessee. My practice concentrates on individual and small business bankruptcy cases, representing trustees, creditors, debtors, and other interested parties in Chapter 7, 11, 12 and 13. In addition, I serve as an Adjunct Professor lecturing on bankruptcy matters at the Thomas M. Cooley Law School - Auburn Hills, Michigan Campus.

I appear before you, today, in my individual capacity and not as a member or representative of any group, organization or school.

I am honored to be here to share with you my experiences in representing the various stakeholders in small business Chapter 11 bankruptcy cases. I come before this Subcommittee neither pro-debtor nor pro-creditor. I frequently represent debtors and trustees as well as creditors. My law partner, Michael A. Stevenson, is a panel trustee in the Eastern District of Michigan. Thomas J. Budzynski, who is "of counsel" to our law firm has served as an appointed Chapter 12 Trustee in the Eastern District of Michigan. Given that background, I do not have a bias towards one group or the other. But having witnessed the expense and anxiety of my small business clients, I am strongly in favor of reforms that will permit efficient reorganizations on a cost effective basis.

My substantive comments are premised on the firm belief that there must be an alternative to the current process set forth in Chapter 11 when a small business seeks relief in bankruptcy and attempts to reorganize. I do not, however, believe that such an alternative would require one to revisit the Bankruptcy Abuse Prevention and Consumer

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Protection Act of 2005. I agree with those who have called on this body to refrain from reflexive legislative efforts which do not afford a wholesale solution, particularly the comments of the well respected jurist, Honorable Thomas B. Bennett, United States Bankruptcy Court for the Northern District of Alabama, who during his December 5, 2007 testimony before the Senate Committee on the Judiciary when discussing *"The Looming Foreclosure Crisis: How to Help Families Save Their Homes"* stated: "I am here to urge caution and restraint in doing anything which attacks what is only a portion of a greater problem." I strongly agree with the premise: Caution and restraint must be implemented in doing anything which attacks what is only a portion of a greater problem. I hold a view that seems to be shared by all experts in the field whether they are for or against a piece of legislation, which is that any legislative solution should attempt to address the entire problem.

With that in mind, I strongly support amending Chapter 12 to accommodate small business enterprises seeking to reorganize. It is my firm belief that the immediate and long term benefits of such Chapter 12 accommodation would address more than a portion of the greater problem and would provide little risk to those you desire to assist and to those many more not contemplated to be affected by the proposed legislation. This solution benefits everyone involved in bankruptcy. It continues the business operation, retains jobs, and enables creditors to be paid. This is a commendable attempt to obtain balance and increase the potential benefits of a reorganizing bankruptcy case.

As this Subcommittee is aware, reorganization in bankruptcy is obtained through Chapter(s) 11, 12 or 13. The United States Bankruptcy Code provides that a debtor that is not an "individual" may not be a debtor under Chapter 13 of Title 11. 11 U.S.C.

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§109(e). Stated another way, only an individual may be a Chapter 13 debtor. Furthermore, only a family farmer or family fisherman may be a debtor under Chapter 12. 11 U.S.C. §109(f). Because of these restrictions, debtors engaged in business that are not eligible for relief under Chapter 12 or 13, that seek to reorganize in bankruptcy, are required to file for relief under Chapter 11, regardless of size, amount of revenue, or the amount of the creditor base.

Insurmountable challenges are often imposed on both creditors and debtors when a small business seeks relief in the existing Chapter 11. Significant impediments to successful reorganization under Chapter 11 include, among other things, the high costs, balloting, and the lack of a standing trustee. If the goals of the bankruptcy process are to provide a structured environment supervised by the Court in which financially troubled companies may remain in business, continue to provide and create jobs, and restructure and retire debt, Chapter 11 fails miserably in addressing small business issues.

I have represented, or closely interacted with, nearly every party in a typical Chapter 11 reorganizing bankruptcy case. My experience dictates that Chapter 11 obligates debtors, creditors, and equity security holders to invest limited resources in the technical legal process, rather than allowing the parties to specifically allocate those resources to the substantive reorganization efforts. In the best legislative solution, a reorganization of a small business would assist the debtor and ensure that the debtor attends to the critical components of the case. That legislative solution would promote expediency, which is essential for small business cases to succeed. Unfortunately, under the current system, small business cases are rarely resolved expeditiously in Chapter 11. On the contrary, the requirements set forth in Chapter 11 relating to both case

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administration and the confirmation process actually inhibit the efforts of the debtor, creditors, interested parties, and the Court to promptly resolve case issues and confirm plans, thereby driving up the administrative costs and increasing the failure rate of those cases. In my opinion, if feasibility is not a real issue, fast tracking small businesses in bankruptcy proceedings, as frequently happens in Chapter 12, would greatly increase the probability of a successful reorganization and ongoing business and preserve rather than eliminate jobs.

The small business Chapter 11 reorganization cases I have participated in or observed generally possess a number of the following attributes: (1) the debtor is closely held (small number of equity security holders); (2) the debtor has less than $10,000,000 in total debt; (3) the debtor has less than five creditors holding secured claims against the debtor; (4) the debtor has no access to debtor-in-possession financing; (5) creditors are unable or unwilling to commit resources to protecting their rights in the case due to the low potential for significant distributions from the debtor; (6) there is no appointment of a Chapter 11 Trustee or Examiner; (7) the business assets of the debtor have a significantly higher value on a replacement value basis than would be received on the open market at a forced sale; (8) few creditors actually participate in the case; (9) few creditors cast ballots; and (10) the debtor is unable to satisfy administrative expenses in full at plan confirmation.

I have participated in or observed a number of successful Chapter 13 business bankruptcy cases. With limited exception, those Chapter 13 cases shared a number of attributes with small business Chapter 11 reorganization cases: (1) less than five creditors held secured claims against the debtor; (2) the debtor had no access to debtor-in-

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possession financing; (3) creditors were unable or unwilling to commit resources to protecting their rights in the case due to the low potential for significant distributions from the debtor; (4) the business assets of the debtor had a significantly higher value on a replacement value basis than would be received on the open market at a forced sale; (5) few creditors actually participated in the case; and (6) the debtor was unable to satisfy administrative expenses in full at plan confirmation.

In this context, I have marveled at the efficiency of the Chapter 13 process, the modest administrative expense cost of Chapter 13 in relation to Chapter 11, the usefulness of a standing trustee, and the benefits inuring to both the debtor and the creditors once a plan is confirmed. As a result, I am convinced that Chapter 12 is a good fit for the small business debtor. The Chapter 12 requirements of 11 U.S.C. §1222 (Contents of Plan) and 11 U.S.C. §1225 (Confirmation of Plan) are well suited for the traditional small business debtor. Those provisions are quite similar to the Chapter 13 requirements of 11 U.S.C. §1322 (Contents of Plan) and 11 U.S.C. §1325 (Confirmation of Plan). These provisions afford exceptional flexibility in both plan formulation and the confirmation process. In light of the cumbersome nature of Chapter 11 and the fragile nature of many small business debtors, the resulting lower administrative expenses incurred by a debtor in Chapter 12 recommend this alternative. So too, creditor costs would be lower in Chapter 12. Balloting and unsecured creditors committees will give way to an independent and disinterested Chapter 12 standing trustee who would represent the interests of all creditors. Inasmuch as feasibility is a condition of confirmation in Chapter 12, a judicial gatekeeper will have a better ability to maintain its docket and the integrity of the bankruptcy system by expeditiously confirming, converting or dismissing

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these cases. In the Eastern District of Michigan, where I practice, we have an exceptionally diligent, albeit extremely overworked, Court.

I am willing to further assist the Members of this Subcommittee and its staff with the task of determining how best to reform the current Chapter 11 process as it relates to small businesses seeking relief in bankruptcy which has precipitated the subject matter of this hearing.

Mr. Chairman, I thank you and the other Members for allowing me to present my views and offer my testimony.

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Statement of

The Honorable Russ Feingold

United States Senator
Wisconsin
March 17, 2010

Statement of U.S. Senator Russ Feingold

Senate Judiciary Committee, Subcommittee on Administrative Oversight and the Courts
"Could Bankruptcy Reform Help Preserve Small Business Jobs?"

March 17, 2010

Mr. Chairman, I want to thank you for holding this hearing. This is a very important topic, particularly in the current economic climate. Frankly, it is refreshing to see our committee approaching the issue of amending the bankruptcy code from the point of view of trying to understand the impact on the overall economy of the current system and evaluating the potential to improve the lives of people by revising that system. Too often in the past, there seemed to be an approach of putting the demands of certain powerful players before the interests of the country as a whole. I still believe that the 2005 bankruptcy reform bill was a mistake in many respects and I hope that at some point this committee will be able to undertake a serious and dispassionate examination of what the real effects of that law have been.

One thing that the 2005 law got right was modifying Chapter 12 to make the law more sensitive to the unusual financial circumstances of family farmers. I appreciate the work that the Senator from Iowa did to keep the positive changes that he and I championed in the bill.

Now we have a proposal to open up Chapter 12 to small businesses. This is an intriguing idea because it seems to present the possibility of giving more small businesses the chance to reorganize rather than liquidate, which in turn will save jobs. As we've heard many times, small businesses employ around half the workers in our economy. So making sure that those businesses have every opportunity to succeed and thrive is a top priority for Congress. As our witnesses note, however, we need to carefully analyze the effect of any changes we might make on the overall economy, including the availability of credit.

Chapter 11 doesn't work for a lot of businesses. Whether that is because of shortcomings in the law, or because many businesses really can't or shouldn't be saved, is the key question. We should not assume, however, that just because current law isn't working, it can't be made to work better with thoughtful modifications. That is what we did with Chapter 12 in 2005, and I think this hearing is a good start to gathering the information we need to decide if Chapter 12 should be opened up to small businesses or if modifications to Chapter 11 would be a better approach. Mr. Chairman, I commend you for examining these issues, and I want to thank all of the witnesses for their thoughtful testimony.

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Statement of Senator Grassley for Judiciary Subcommittee Hearing "Could Bankruptcy Reform Help Preserve Small Business Jobs?"

Mr. Chairman, thank you for holding this hearing today. It is important that the Judiciary Committee study whether small businesses are experiencing problems with reorganization in bankruptcy, and whether changes to the Bankruptcy Code are necessary. Small businesses are a primary driver of our economy, so we want to ensure that viable small businesses have every opportunity to reorganize and succeed. In fact, the Bankruptcy Reform Act of 2005 included several provisions with respect to small businesses that were derived from recommendations of the National Bankruptcy Review Commission and intended to improve the bankruptcy process for small business owners. We should determine whether those provisions are working, and assess whether further improvements – such as reducing administrative costs and streamlining procedures – can be made to the process to address the special problems presented by small business bankruptcies.

At the same time we need to take care that we not acerbate an already tight credit environment for small businesses or frustrate their ability to work with other businesses. Small businesses depend on lenders and other businesses, including other small businesses, to get started and to operate successfully. We should ensure that any changes we make to the bankruptcy rules do not disrupt business dealings, increase borrowing costs for small businesses, or decrease the availability of small business credit. We should also ensure that any changes we make do not encourage gaming of the bankruptcy rules or incentivize fraud and abuse in bankruptcy filings.

So I am open to making changes to improve the bankruptcy rules for small businesses. However, the National Bankruptcy Conference has proposed amending Chapter 12 to apply to small businesses to address their concerns. I am opposed to such an expansion of Chapter 12. I drafted Chapter 12 to respond to the specific problem of small farming operations being unable to reorganize in bankruptcy. Chapter 12 was carefully crafted and narrowly targeted to small family farmers and family fishermen. I'm extremely concerned that if Chapter 12 were opened to non-farm business filings, Chapter 12 filings would expand dramatically and potentially create large adverse economic effects that could result in a backlash of opposition against Chapter 12. In fact, the National Bankruptcy Conference Report itself states that their proposal would substantially increase Chapter 12 trustee workload. During calendar year 2008, there were only 345 Chapter 12 filings but nearly 10,000 Chapter 11 cases - with the bulk of Chapter 11 cases filed by small businesses.

Again, I want to make clear that my opposition to expanding Chapter 12 to small businesses does not mean that I am not open to looking at changes to the Bankruptcy Code to facilitate reorganization for small businesses. In my opinion, after we determine what best should be done to improve the bankruptcy process for small businesses, it would make more

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sense to either amend Chapter 11 or create a separate Chapter in the Bankruptcy Code for small business reorganizations.

I look forward to hearing the witness testimony and working with the members of the Judiciary Committee on finding the right approach to this issue.

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Testimony of Joseph R. Mason

Hermann Moyse, Jr./Louisiana Bankers Association Professor of Finance,
Louisiana State University and Senior Fellow, the Wharton School

Before the Senate Committee on the Judiciary,
Subcommittee on Administrative Oversight and the Courts

March 17, 2010

"Could Bankruptcy Reform Help Preserve Small Business Jobs"

I want to thank Chairman Whitehouse, ranking Member Sessions, and the members of the Subcommittee for inviting me to testify on this crucially important topic.

Bankruptcy law is a crucial stabilizer to economic growth. The philosophy that indebted persons should be able to carry forward after discharging as much of their debt as possible without being completely wiped out has been held dear for several hundred years. But even from the inception of that philosophy, it has also been held that some individuals and entities deserve special treatment relative to others. The British roots of bankruptcy law, therefore, allowed relief for the landed but not the commoner.

US bankruptcy law is no different, giving the landed interests similar special treatment. The rationale for such treatment in the US, however, was not peerage but the perceived importance of farmers to US economic growth since the times of Thomas Jefferson. The idea is that the "uncertain nature of the farm business with its attendant wide fluctuations in commodity prices and frequent weather problems," deserved special consideration. Such treatment was accompanied by restrictions on financial institutions that lent money to the farms, so that those would be so undiversified – as well as legally hobbled in bankruptcy law – that they had no alternative but to forbear on farmers in times of poor harvests.

As the US economy grew and as industrialization took hold, the traditional family farm became considered a "small business." As railroads and banks took precedence for special treatment in the bankruptcy code, bankruptcy concerns for small businesses of all types fell by the wayside. It is laudable, therefore, that the Subcommittee consider changes to the bankruptcy code that can make sense of some of the dynamics of today's volatile business environment.

Unfortunately, the approach under consideration will hurt both economic growth as well as small business owners. The proposed remedy does not separate between business and personal asset in a manner that can clarify business and personal financial relationships a priori, therefore reducing

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unexpected distress ex post. In fact, nothing can ever fully solve the business bankruptcy problem because it, like personal bankruptcy, is caused primarily by several well-known triggers that typically manifest at very personal levels. Moreover, even changes to bankruptcy code cannot stem the tide of macroeconomic troubles, but only help entrepreneurs smooth the transition to new opportunities and help creditors retain value. Both, preserved, will be more prone to drive economic growth than if both creditors and entrepreneurs waste time and money sorting through the rubble to try to find something of value, preserving meager economic activity at the cost of high growth potential.

Small Business Assets and Personal Assets and Liabilities are Often Commingled

It is hard, sometimes, to see where the boundaries of personal lives and business lives exist, especially in small businesses. Small business owners often work out of their homes or finance business investment on their personal credit cards. Small businesses are more likely to contract on insufficient terms or fail to carry sufficient liability insurance. And small businesses are more prone to personal liability on the part of the business owner or partners, as a result.

One simple example is the prevalence of small business subprime home lending that played a part in the run-up to the recent crisis. While there are no official figures on such activity, a significant number of the firms active in such lending experienced dramatic difficulties well before the common crisis. One such firm, American Business Financial Services, was the subject of its own spectacular bankruptcy in the Philadelphia region early in the crisis.

American Business Credit originated "business purpose loans to corporations, partnerships, sole proprietors and other business entities, or to individuals, for various business purposes... collateralized by a first or second mortgage lien on a principal residence of the borrower" American Business Credit generally charged origination fees of 4.75% to 5.75% of the original principal balance. The weighted-average (simple) interest rate on American Business Credit's portfolio for the first six months of fiscal 2003 was 15.86%. According to the company, "although prepayment fees

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imposed vary based upon applicable state law, the prepayment fees on American Business Credit's business purpose loans can be a significant portion of the outstanding loan balance."[1]

ABFS and others ultimately found that small business owners of any particular credit quality were more likely to repay their mortgages in the event the ABFS held sway not only over their home, but their business as well. Such subprime business loans explicitly exploit the commingling of business and personal assets for greater profitability and repayment. I argue that it is those boundaries between the personal and business obligations that lead to the most disruptive losses in small business bankruptcy.

The Causes of Small Business Bankruptcy and Personal Bankruptcy are also Commingled

While many studies (as well as conjectural notions) seek to categorize the causes of small business bankruptcies, the chief risks are cash flows, lawsuits, and key-man risk. Cash flows speak for themselves. Microbusinesses can go bankrupt if a single client misses a payment. Sometimes there can arise a domino effect (we call that systemic risk in the financial world) where the failure of one small business to get paid results in it not being able to pay others. Such trickle down is common in the construction business, where a contractor will fail to pay their subcontractors. That is why every homeowner knows to contract in a manner in which the subcontractors only have recourse to the contractor, not the homeowner.

Small businesses that serve larger business clients can often have payments held up, as well. If the small business turns down subsequent business before getting paid for the previous contract, they can lose a significantly large client. If they choose to litigate, they can lose the entire amount and the client to attorneys. As mentioned above, small businesses are more likely than large

[1] American Business Financial Services, Inc. and a number of its subsidiaries filed for protection under Chapter 11 of the Bankruptcy Code on January 21, 2005. The firm is now in liquidation. Prospectus of Bear Stearns Asset Backed Securities Inc. 424B5, "ABFS Mortgage Loan Trust 2003 1" 3/31/03, at S-35, http://www.secinfo.com/dr89b.2fp.htm#23iy

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businesses to have significant shortfalls in liability coverage. Hence, in the event a client sues over a job – whether for completion or injury – the small business owner can lose both personal and business assets.

Of course, a skilled manager can help guide a business through those landmines. But the skilled manager in small business is often the owner or managing partner, and without him or her, the business cannot stand. Consider the chief risks facing the "key-man" in the operation are the same personal financial shocks that cause personal bankruptcy: divorce, automobile accidents, health care crises, and addictive disorders. [2]

Change is Costly, so Let's Make it Worthwhile

We are still dealing with the fallout of changes to bankruptcy incentive in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. There, liberal rights granted to unsecured consumer creditors led to increased credit supply and rampant consumer borrowing. On the business side, "BAPCPA's extension of safe harbor provisions to a seemingly unlimited universe of financial contracts… dramatically increased the number of parties who could freely terminate or accelerate agreements, liquidate positions, and set off claims against margin or collateral called in from a debtor without fear of interference by a bankruptcy court."[3] As a result, failed firms had already been drained dry of cash and assets by margin calls on new financial products, leaving the firm a mere shell in the aftermath.

Similar dramatic changes occurred with the implementation of Chapter 12. Shortly after Chapter 12's implementation, agricultural experts argue that "It is doubtful that there currently exists a single provider of funds, farm supplies, and/or agricultural services which has not been directly or indirectly impacted by the advent of Chapter 12. Indeed, some major suppliers of fuel, seed,

[2] See, for instance, Mason, Joseph R., "Demographics and Personal Bankruptcies," Research in Banking and Finance, v. 1, pp. 229-257, 2000.
[3] Julia Whitehead, Viewpoint, Dow Jones DBR Small Cap, Wednesday, April 22, 2009.

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fertilizer, and chemicals, operating as large-scale holders of unsecured claims on agricultural producers, have been forced into Chapter 7 liquidation as a result of their customer's treatment under Chapter 12. In our highly integrated and interdependent agricultural economy, it would appear that the domino theory is well supported by recent experience."[4]

As a result, while Chapter 12 appears to have provided a short-run benefit to family farmers in crisis, it has become a burden to secured creditors. Under the revised Chapter 12, secured creditors were, "forced to make a loan equal to the liquidated value of their claim," even though the farmer had no equity to contribute himself.[5] This turned many agricultural creditor relationships upside down, leaving *secured* creditors to bear the downside risk, while unsecured creditors and farmers gained the upside. Ironically, unsecured creditors (largely providers of farm production supplies) who would normally stand to receive little under a Chapter 7 liquidation, in fact, stood to benefit from Chapter 12 proceedings.[6]

Each time we tinker with bankruptcy law, we impose significant costs on all economic agents. We all know the classic tradeoff. "Higher bankruptcy exemption levels benefit potential entrepreneurs who are risk averse by providing partial wealth insurance and therefore that the probability of owning a business increases as the exemption level increases.[7] But "higher personal bankruptcy exemptions are predicted to cause increased credit rationing and higher interest rates."[8] In a recession, it will be crucial to get the balance right so as not to choke off investment and

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[4] Duft, Ken D. "Chapter 12 Bankruptcy in Retrospect; Its Impact on Agribusiness Firms," Agribusiness Management, Washington State University College of Agriculture, Cooperative Extension, http://www.agribusiness-mgmt.wsu.edu/ExtensionNewsletters/cash-asset/Chap12.pdf at 6.
[5] Innes, R., E. Keller, and H. Carman. "Chapter 12 and Farm Bankruptcy in California." California Agriculture, Vol. 43, No. 6, Nov.-Dec. 1989, pp. 28-31.
[6] Duft, Ken D. "Chapter 12 Bankruptcy in Retrospect; Its Impact on Agribusiness Firms," Agribusiness Management, Washington State University College of Agriculture, Cooperative Extension, http://www.agribusiness-mgmt.wsu.edu/ExtensionNewsletters/cash-asset/Chap12.pdf at 8.
[7] Michelle J. White and Wei Fan, "Personal Bankruptcy and the Level of Entrepreneurial Activity," Journal of Law & Economics, vol. 46:2, October 2003, pp. 543-568.
[8] Michelle J. White and Jeremy Berkowitz, "Bankruptcy and Small Firms' Access to Credit," RAND J. of Economics, vol. 35:1, pp. 69-84, Spring 2004.

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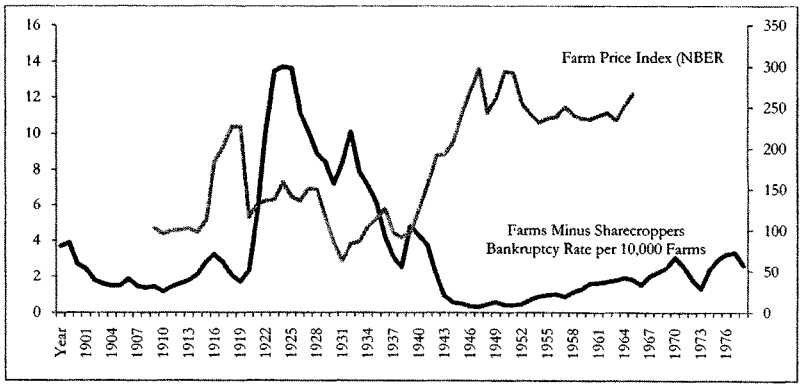
economic growth. The problem is that we will experience large numbers of bankruptcies whatever balance is struck.

Bankruptcy Law can Only Help Smooth Short-term Business Fluctuations, not Secular Trends

As stated earlier, we will never do away with business bankruptcies, large or small. Consider, for instance, the classic Ricardian characterization of frontier development. Farms on even the most distant edges of the frontier become profitable – despite high transportation costs and low soil quality/productivity – in times of high prices. It is considered unpalatable to tell farmers they cannot move to such places while prices are rising (and, indeed, it would be economically harmful as prices would increase faster and farther than would otherwise be the case). The problem is it is also considered unpalatable to allow those farms to fail when prices (inevitably) fall. The figure below shows, however, that over 1910-1968 farm bankruptcies have been highly correlated with farm price indices: farm prices stay high, bankruptcies stay low, and vice versa.



The figure also shows that farm prices, at least in the past, fell from roughly 1917 to 1940, a 22-year period that even liberal bankruptcy laws could not bridge. But if you look closely at the

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figure, the problem is not really the 22-year decline from 1917 to 1940, but the WWI bubble in agriculture prices from 1914-1917. Without the dramatic increases in agricultural prices in WWI, the decline in the 1920s and afterward would most likely not have occurred. As Ricardo described, the problem was too many farms on the inframarginal periphery – the dust bowl – that had little long-term productive potential. Indeed, when Europe began again to compete on world agricultural markets, that inframarginal dust bowl land was the first to be abandoned.

Today, we are on the other side of another bubble, this time a financial market and housing bubble rather than an agricultural bubble. We can predict with confidence that there will be many business failures and among them a large proportion of small business failures. But just like those dust bowl farms, many of those businesses were only viable for a small period of time in a very special competitive environment, which no longer exists.

The challenge before us, therefore, is not how to prevent bankruptcies, for that would be akin to sentencing farmers to die on their dust bowl land. Rather, the greatest challenge is to craft a small business bankruptcy law that can be used. Chapter 12 is probably not the answer. "...Empirical evidence shows that very few farmers actually use Chapter 12 and that bankruptcy relief has not and cannot halt the decline in family farming."[9] It won't save small businesses from a recession, either.

From an economic point of view, we want a small business bankruptcy law that smoothes the transition of the serial entrepreneur, allowing them to flow into and out of businesses in a way that preserves both creditor and entrepreneur value. Such a balance can, indeed, be struck. Some elements, however, remain counterintuitive to policymakers both in the judiciary and banking worlds. Economically, the simple key to retaining value is to intervene *earlier* than is currently the case. Of course, that means more bankruptcies. But as Michelle White famously wrote of personal

[9] Porter, Katherine M., Phantom Farmers: Chapter 12 of the Bankruptcy Code. American Bankruptcy Law Journal, Vol. 79, p. 727, 2005.

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bankruptcies even before BAPCPA, the surprising aspect of bankruptcy is not how *many* people use it, but how *few*.[10]

Overall, a leaner Chapter 11 system with simplified filing and streamlined procedures for quick recovery will help those who have the capacity get back to business while preserving collateral value and saving on legal bills for others. Such a system has the potential to be an important impetus for economic growth in the coming recovery.

[10] Michelle J. White, "Why Don't More Households File for Bankruptcy?" Journal of Law, Economics, and Organization, vol. 14:2, pp. 205-231, October 1998.

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Ancillary Testimony of Joseph R. Mason

Hermann Moyse, Jr./Louisiana Bankers Association Professor of Finance,
Louisiana State University and Senior Fellow, the Wharton School

Before the Senate Committee on the Judiciary,
Subcommittee on Administrative Oversight and the Courts

March 24, 2010

"Could Bankruptcy Reform Help Preserve Small Business Jobs"

58267.086

In response to Sen. Whitehouse's request, I am providing additional detail on positive recommendations for small business bankruptcy reform. As discussed in the hearing, it is my opinion that small businesses are better served by an extension of Chapter 11 than an adaptation of Chapter 12. That extension should provide a reorganization mechanism that is fast, certain, preserves absolute priority of claims, and preserves creditor relationships.

The last of these is crucial, as all businesses -- and especially small businesses -- face troubles shrinking or dissolving. The idea should be to facilitate a dynamic that accommodates shrinking, as well as growth. Part of the idea should be to minimize losses by providing a mechanism that may not even be called bankruptcy, but something more amenable to the business owner, so that they are *encouraged* to shrink their operations when necessary. Of course, doing so will not be accomplished without some loss, but the loss through such an approach can be minimized by encouraging the owner to act early, preserving creditor value and therefore creditor relationships.

Preserving the absolute priority of claims is crucial, as well. Chapter 12 was built to handle a small business with a single large asset, a farm or fishing boat, as a factor of production. Hence, the template does not easily generalize to other cases. In particular, the Chapter 12 approach has resulted in the secured lender on the fixed asset taking a preponderance of the loss, while the unsecured lender for operating capital is satisfied.

Such a tradeoff is necessary with a single large asset because if you impose a loss on the unsecured lender of operating capital, that lender will just refuse to lend next period. Without those large assets, however, absolute priority of claims is easier to maintain. Attention to such detail will reduce the disruptive potential of small business reorganization.

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Holding up secured lenders also violates the absolute priority rule. A small business bankruptcy Chapter needs to provide certainty as to whether the reorganization will be allowed to proceed in short order. Unlike a large firm, there is no need to spend years investigating the firm: it will be pretty obvious whether the firms can be restored to a viable going concern or not. When it is not, secured lenders need to be allowed to repossess their collateral.

You should not fear allowing secured lenders the ability to do so, because lenders – preferring to be repaid – never really want the collateral, anyway. Even in today's housing market, secured lenders are acting to smooth market forces, repossessing homes and other property where there is an active secondary market for such items and forbearing where there is not. Another way to say this is that lenders repossess where there is a more valuable use to the property, as demonstrated by market prices. It is economically efficient to apply capital to its most valuable use. We need that efficiency to emerge from recession and stagnant growth following the credit crisis.

Last, the small business cutoff must be meaningful. While I am loath to say "leave it up to the court," I am equally loath to set a specific employee or asset size cutoff. Perhaps the solution is to set a bright-line minimum and allow judges to accept cases above that minimum up to some obvious maximum. Such a framework would also allow the characterization to adapt over time and across regional economies.

In closing, by focusing on creating a reorganization mechanism that is fast, certain, preserves absolute priority of claims, and preserves creditor relationships, we can meaningfully address the needs of America's small business and create a better contracting environment for credit availability that can play a meaningful role in the economic recovery.

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Chairman Whitehouse, Ranking Member Sessions, thank you for the opportunity to appear today before this subcommittee to tell my story and for looking into ways to help small businesses stay open.

My story begins at the end of 1995 when I decided to open a full-scale health club in Warren, Rhode Island. I had a degree in Nutrition, experience with Personal Training, and lifelong involvement in sports, martial arts and exercise. I grew up in the area and recognized the need for a health club, so I placed a full page ad in the local paper, "Coming Soon! East Bay Fitness".

Shortly thereafter, I secured a reasonably priced location. I moved into the building and began to renovate it 24/7 with the help of family and friends. During this time I met a grad student who wanted to invest in a business. We negotiated a five year arrangement and he invested his $50,000.

In October of 1996, we officially opened the doors. Though the location was not ideal and the business was very young, East Bay Fitness grew into a successful and well established business. We were actually profitable from day one. We put every dollar back into the business and continued to improve and grow over the years. In 2001, we were able to endure the opening of a larger, better funded competitor because our customer base was so loyal.

In 2005, things took an unexpected turn when our landlord refused to renew our lease. While moving to a new facility in a better location was definitely part of our long term strategy, the news was devastating at that time. Our type of business requires a large open floor plan on a main road and there were few suitable locations in the area. To make matters worse, we didn't have the cash necessary to build out a new location. We were on the verge of losing everything we had worked so hard for all those years.

Despite the daunting challenges, I decided to attempt to move the club. I knew that if I was going to pull this off, I had to make sure that I did everything right. So, the first thing I did was to enlist the expertise of a health club design and marketing firm that built clubs all over the world. They began with a market analysis and we began the search for potential locations.

We found ourselves with no other option than to lease space. At that time there were only two spaces available for lease. Late summer/early fall of 2006, we finally negotiated a deal to move into a shopping plaza and applied for the financing. Our financing needed to be secured by my personal home and assets.

Now that we had the financing in place, we were just waiting on the actual lease documents to be finished. We needed to begin the renovations right away in order to make a January opening date. In the Health Club industry, the first quarter sets up the rest of the year as people are more inclined to join after making New Years resolutions. As negotiations on the lease for the plaza space dragged, another space opened up and we signed the lease in April of 2007.

In the fall of 2007, we had the new space completely gutted and began the sandblasting and sealing of the wood beam ceiling and brick walls. We also began the closing process with our bank. We had hopes of a January opening – to seize on the New Years resolutions crowd – and continued to do what we could to keep the project moving forward. However, it wasn't until January that we were finally ready to close on the loan.

Days before the closing date was ready to be set, the bank informed us that there was a UCC filing that had to be cleared before proceeding with the closing. Unfortunately, because my business partner couldn't use any collateral, the bank that financed her stock purchase filed a UCC against the shares.

By the time we found a solution and notified the bank that we were going to clear the UCC filing they informed us that our file had been taken out of closing and sent to storage in another state. We then had to begin the closing process over again and had to resubmit all documentation. We were informed by a bank employee that through the course of our loan everyone at the bank involved with our loan had either been fired or quit at some point during the process. Within the bank there was a lot of confusion, miscommunication and misplaced documents, etc. This caused the whole process to be far longer and more painful than it should have been.

The delays ultimately caused our original landlord to evict us in the summer of 2008. The eviction process began in July of 2008 when our landlord literally began taking over our space and renovating around our customers while we were still trying to operate. Immediately, our sales dropped $10,000 (25%) per month.

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Luckily, we found a small vacant building around the end of September that was to serve as a temporary location. It wasn't ideal but it saved us. We operated there until we opened the new facility in April of 2009.

We finally closed on the loan in October of 2008 and the club opened in April of 2009 --2 years behind schedule.

Our average sales prior to the eviction were $40,000 per month, enough to cover minimal expenses at the new location including the new debt service. Average sales after eviction were $30,000 per month. A year of normal operations and growth in the new facility would have put us back on track.

By the time the new club was open we were behind in bills and needed to free up cash flow so we would have a chance to breath and focus on growing. We were looking for help everywhere, RIEDC, SBA, our banks, new banks, private investors, etc. We had applied for an ARC loan to pay our equipment leases. If approved, it would have freed up $7,000 a month in working capital for 5 months. We couldn't even get banks to take the application never mind consider it. They said they did not want to do the paperwork. We also applied for a deferment with our bank. We were told by the SBA that our bank could approve a deferment for up to 1 year without SBA approval. It took 4 months and a lot of paperwork just to get an answer. We were eventually granted a 3 month interest only deferment. Unfortunately, this would not be a significant help.

An ARC loan and a longer loan deferment by themselves probably would have been enough to save the business if granted soon enough. This would have given us the time we needed to grow and catch up on the past due bills. When we closed we had accumulated approximately $140,000 in past due bills. Half of that amount also would have saved the business while we caught up with the rest over time. I guess when you look at the big picture a relatively small amount of assistance could have helped us avoid having to go bankrupt with over 1 million dollars in debt.

A little flexibility on timing could have saved our business. Last year, we met with a bankruptcy attorney hoping that, if we filed, we could buy enough time to make it to the first quarter of the year and get our business back on track. Unfortunately, the attorney told us that our business value was too small to warrant reorganization in Chapter 11. The only bankruptcy option for us was liquidation.

We have now lost the business, our entire life savings, our credit, and now probably our house which was used to secure the bank loan. It didn't have to be this way. Timing worked against us. If we had more time, we could have stayed in business, become profitable again, and avoided laying off 25 full-time and part-time employees. Senators, please consider ways to help small businesses like mine have a fighting chance to stay in business. Thank you and I'm happy to answer any questions.

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March 17, 2010

Honorable Sheldon Whitehouse
Hart Senate Office Building
Room 502
Washington, D.C. 20510

Dear Senator Whitehouse:

For more than a century, the National Association of Credit Management (NACM) has represented the interests of trade creditors across the country. Our members are predominantly small businesses and manufacturers, two sectors of the business world who, now more than ever, have a vested interest in a Bankruptcy Code that functions effectively and for the benefit of all parties.

NACM recognizes the important role that small businesses play in the economy and in the nascent stages of our nation's return to economic prosperity. Our previous advocacy efforts have focused on changes to the Bankruptcy Code that would benefit these smaller firms. However, despite the progress made on behalf of small businesses with the enactment of the BAPCPA, NACM still believes that the bankruptcy process for small companies is not working as well, or as cost effectively, as originally hoped.

It is clear that the less time a small business spends in the reorganization process, the more assets are preserved in that business' bankruptcy estate for creditors and for the business itself. To the extent that Congress is willing to revisit the Bankruptcy Code as it applies to small businesses, NACM supports actions that would seek to improve the process for smaller firms.

In concept, NACM would support actions that expedite the reorganization and rehabilitation process for small businesses. NACM's position has always been that a small business should not languish in a Chapter 11 case, to the detriment of both the business and its creditors. Additionally, NACM recognizes that small firms frequently cannot afford to reorganize in Chapter 11, which is most effective when dealing with larger companies. NACM would, therefore, support actions that offer small businesses a viable expedited reorganization option that also reduces administrative costs. Finally, NACM believes the bankruptcy process should take into account the interests of all parties in the case and would support actions that make this a reality without overburdening the system.

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Honorable Sheldon Whitehouse
March 17, 2010
Page Two

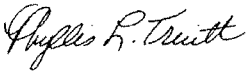
We look forward to working with you and your office on making these improvements a reality and ensuring that small businesses and the economy at large get the most out of our nation's Bankruptcy Code.

Thank you for your time and consideration.

Sincerely,

Robin Schauseil, CAE
NACM President

and



Phyllis L. Truitt, CCE
NACM Chairman
and
Director of Credit
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Testimony of

A. Thomas Small

on behalf of the

National Bankruptcy Conference

before the

Senate Judiciary Committee's Subcommittee on
Administrative Oversight and the Courts

111th Congress, 2nd Session

on the subject of

"Could Bankruptcy Reform Help Preserve Small Business Jobs"

March 17, 2010

The National Bankruptcy Conference is grateful for the opportunity to participate in this hearing and to present its recommendation to expand chapter 12 to include small business enterprises. The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and on any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees. Also attached is the Conference's proposal.

Today, many small businesses are in financial distress - and they need and deserve a fair and efficient vehicle to reorganize their capital structures. Unfortunately, the federal bankruptcy laws, as currently written, do not serve this purpose well. If a small business that is organized as a corporation, a limited liability company or a partnership wishes to avoid liquidation, it must use Chapter 11 of the Bankruptcy Code. However, Chapter 11 was designed for large companies, and works poorly, or not at all, for small businesses.

Recognizing this problem, the National Bankruptcy Conference has studied the current situation and now proposes an alternative, which is described in the attached "Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking Reorganization." As we explain in the Proposal, Chapter 12 of the Bankruptcy Code - which is currently available to family farmers and family fishermen - provides a time-

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tested, fair and effective means to reorganize businesses, which should be expanded to apply to small businesses.

Once again, thank you for inviting the National Bankruptcy Conference to testify at this important hearing. Allowing small business enterprises access to chapter 12 will not help all small businesses that are in financial distress, but it will provide many with a chance to survive and prosper, preserving going concern values for the benefit of creditors and saving jobs for their employees. The Conference would be happy to provide any additional information if the Committee would find it helpful. The Conference also would be pleased to formulate drafting proposals and assist in technical matters.

A. Thomas Small

United States Bankruptcy Judge - Retired
Co-Chair Small Business Working Group
National Bankruptcy Conference
tomsmall@nc.rr.com

NATIONAL BANKRUPTCY CONFERENCE

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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* Senior Conferees

12/7/09

A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize

National Bankruptcy Conference

January 3, 2010

Executive Summary

Today's small businesses have few options when they suffer financial distress. If they want to avoid liquidation, and if they are organized as a partnership or corporation, they must use Chapter 11 of the Bankruptcy Code. But judges, attorneys, and academics have known for years that Chapter 11 works poorly or not at all for small businesses. This law was designed for large corporations with extensive operations and complex capital structures, not small enterprises that depend critically on the skills of a single owner-manager and family members. The model for Chapter 11 was the publicly-traded manufacturer, not the local diner. As a result, many distressed small businesses are forced to wind down using antiquated state-law procedures instead of Chapter 11. If they do enter Chapter 11, their cases are often dismissed or converted to liquidation. The few that do succeed at reorganizing find that 20 percent or more of their assets were consumed by the administrative costs of the bankruptcy process.

There is a simple solution to this problem, and it already exists in another chapter of the Bankruptcy Code: Chapter 12, which now offers a reorganization opportunity for family farmers and family fishermen. This chapter provides a time-tested, successful model for efficient reorganization of small businesses. We recommend making it available to small businesses generally. With appropriate modifications, outlined in our proposal below, Chapter 12 would fill a gap in the reorganization laws for small businesses, save a significant number of viable small businesses from liquidation, and lower the costs of business failure for both small businesses and their creditors.

Our proposal begins with a statistical profile of small business bankruptcy, documenting the ill-fitting match between existing Chapter 11 and the problems of most small businesses. We then propose Chapter 12 as the appropriate solution and show that few legislative changes would be required to make this Chapter accessible to small businesses. The appendix presents the statutory amendments that would be necessary.

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I. Motivation: Chapter 11 is a poor fit for small businesses

Bankruptcy judges, practitioners, and academics have known for decades that Chapter 11 works poorly or not at all for small businesses. There are many good reasons for this misfit. Fundamentally, Chapter 11 was conceived as a "big" business chapter with public companies as the model. Complex debt and asset structures arguably justify the SEC-style disclosures, multi-layered plans, voting and the like that characterize money-center Chapter 11 cases.[1] These same features make Chapter 11 too expensive, too complicated and too time consuming for small business debtors and their creditors.

Although a number of courts have fashioned local rules and practices that soften the unwelcoming aspects of Chapter 11,[2] they are limited to working with blunt tools, such as deadlines for submitting a plan and the threat of dismissal or conversion to Chapter 7. Some Local rules and practices have been counteracted by recent legislation (in 2005) that makes Chapter 11 less hospitable to small businesses by increasing disclosure requirements, compressing the time available, swamping cases with administration, and setting "drop dead" traps at every turn.[3]

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[1]*See, e.g.*, Hon. Leif M. Clark, *Chapter 11–Does One Size Fit All?*, 4 AM. BANKR. INST. L. REV. 167, 170-75 (1996).

[2]*See* Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305 (1993); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 205-07 & nn.78-85 (2000) ("The initiative in dealing with [the small success rate of small businesses in Chapter 11] came from the courts. Beginning in the late 1980s, some judges began to use their discretionary power to create a system of case management under which they could quicken the pace of cases that were proceeding too slowly and could more rapidly dismiss, or convert to Chapter 7, cases that had poor prospects of successful rehabilitation. The best known of these methods came to be known as the 'fast-track.' In essence, the fast-track procedure provided for an early evaluation by an official equivalent to the U.S. Trustee of all cases filed, to determine if they should be subject to an accelerated deadline for filing the plan. There were no specific articulated guidelines for this determination, which was made case by case and was not confined to debtors below any defined size. If the case was one for which accelerated treatment was appropriate, the court would order the debtor to file a plan by a specified date, usually sixty to ninety days following the order for relief. In addition, instead of following the usual (indeed, it can be argued, the required) procedure of conducting a formal hearing on notice to approve the disclosure statement before acceptances of the plan were solicited, the court informally reviewed the disclosure statement and would provisionally approve it if it appeared adequate. The final approval hearing, with an opportunity afforded for objections to the statement, was postponed to be combined with the plan confirmation hearing. If the debtor missed the deadline for plan filing set by the court, the case could be dismissed or converted unless the debtor could show cause for the delay. A short extension may have been granted if the plan was not confirmable, but the debtor would not be allowed wide latitude in producing a timely confirmable plan.") (footnotes omitted).

[3]*See, e.g.*, 11 U.S.C. §§ 308 (small business debtor reporting requirements), 1116 (additional duties of a debtor or trustee in a small business case); 1121(e) (reorganization plan must be submitted within 300 days), 1129(e) (plan must be confirmed within 45 days after plan is filed); 28 U.S.C § 586(a)(7) (establishing expanded U.S. Trustee duties and responsibilities in small business cases). *See also* Hon. A. Thomas Small, *If You Fix It, They Will Come–A New Playing Field for Small Business Bankruptcies*, 79

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This section presents a statistical profile of the challenges small businesses experience in Chapter 11. Drawing on a wide range of empirical studies, there are four fundamental flaws in the current reorganization process for small businesses:

1. **Excessive Secured Creditor Influence**: Chapter 11 gives secured creditors excessive influence over the process,
2. **Monitoring Deficits**: Chapter 11 fails to give the judge or trustee sufficient information to monitor the firm's viability,
3. **High Costs:** Chapter 11 generates exorbitant administrative costs,
4. **Obstacles to Reorganization**: Chapter 11 includes a set of procedures (due in part to the reforms of 2005) that create serious roadblocks to reorganization.

Section II explains how Chapter 12 can remedy these problems.

A. Small Business Chapter 11s: Basic Facts

Several recent studies have produced basic facts about the small business Chapter 11 process, including:

- IL Study: analyzed bankruptcy filings during 1998 and 2006 in the Northern District of Illinois. The study excluded filings by non-corporate, non-profit, and real estate businesses.[4]
- NY/AZ Study: analyzed filings between 1995 and 2001 in the Southern District of New York and the District of Arizona. The study excluded cases that were dismissed or converted to Chapter 7.[5]
- Multi-District Study: analyzed filings during 1998 and 2006 in a variety of districts (23 districts in 1998 and 9 in 2006). The study includes filings by individuals, partnerships, and corporations.[6]

AM. BANKR. L.J. 981, 982 (2005) ("These provisions probably will not reduce costs, and certainly do not address most of the roadblocks that confront a small business Chapter 11 debtor.").

[4] Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381 (2007); Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005); and Douglas G. Baird & Edward R. Morrison, *Adversary Proceedings: A Sideshow*, 79 Am. Bankr. L.J. 951 (2005).

[5] This study produced Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study*, working paper (2007), and Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. Fin. 1280 (2006).

[6] Papers from this study include Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L. J. 499 (1999).

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- D&B Studies: analyzed Dun & Bradstreet data on small business closures. One study analyzed distressed businesses in Cook County during the period 1998 to 2005.[7] Another analyzed a nationally representative sample of small business closures during 2004 and 2006.[8] Both studies included data on corporations, proprietorships, and partnerships that filed for bankruptcy or shut down without filing.
- Tax Studies: several papers have studied the pervasiveness and composition of small business tax debts.[9]

These studies report the following patterns:

Small businesses have relatively simple capital structures and many wind down or reorganize without filing for bankruptcy. Among businesses with less than $200,000 in assets, the NY/AZ Study found, the median firm has only 1 or 2 secured creditors, neither of which is usually a bank.[10] The number of unsecured creditors is fewer than 20 for the median firm, and a bank is rarely, if ever, among these creditors.[11] Due to the simplicity of their capital structures, distressed small businesses frequently resolve their distress without filing for bankruptcy. For example, the D&B Studies found that 80 percent of distressed businesses wind down or reorganize without filing. Bankruptcy is most attractive to firms with a relatively large number of creditors (e.g., 3 or more secured creditors).[12]

Secured debt accounts for a large share of total debt and assets, but significant value remains for unsecured creditors. Data from the IL Study, for example, show that secured debt accounted for 23 percent of total debt and 51 percent of total assets in the median firm.[13]

Administrative costs of Chapter 11 are significant. Looking across both Chapter 7s and confirmed Chapter 11s, the NY/AZ found that median professional fees equaled 23% of asset value (as reported at filing) among firms with assets worth less than $100,000. Fees equaled 4.9% of assets among firms with assets worth between $100,000 and $1 million and about 1% among larger firms.[14] Another study, of individual and business Chapter 11s in six geographically diverse districts between 1986 and 1993, found administrative costs equal to 3.5

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[7] Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255 (2009).

[8] Edward R. Morrison, *Bankruptcy's Rarity, Small Business Workouts in the United States*, 5 Eur. Company & Fin. L. Rev. 172 (2008); Edward R. Morrison, *Small Business Bankruptcy and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, Report Submitted to the Small Business Administration (2008).

[9] These include Rafael Efrat, *The Tax Debts of Small Business Owners in Bankruptcy*, 24 Akron Tax L. J. 175 (2009); Rafael Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, 4 Hastings Bus. L. J. 175 (2008); Baird, et al., *Dynamics of Large and Small Chapter 11 Cases*, *supra* note 5; and Baird & Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, *supra* note 4.

[10] Baird, Bris & Zhu, *supra* note 2, at 18-9.

[11] *Id.*

[12] Morrison, *Small Business*, *supra* note 1, at 6.

[13] These statistics were computed for this proposal.

[14] Bris, Welch & Zhu, *supra* note 2, at 1282

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percent of assets (at filing) in the median case ("Lawless, et al., Study").[15] Practitioners claim that these costs exceed those of comparable state procedures such as assignments for the benefit of creditors.[16]

Administrative costs and priority tax claims consume the bulk of unencumbered property in confirmed Chapter 11s. The NY/AZ study calculated the median recovery rate for creditors holding non-priority unsecured claims. It was zero among firms with assets (at filing) under $200,000 and around 3 percent among firms with assets under $2 million. Priority tax claims, in particular, constituted a large fraction of total debt, accounting for 20 percent or more of unsecured debt among firms with assets under $2 million.[17] The Lawless et al., Study found that professional fees and other administrative expenses consumed about 18 percent of distributions to unsecured creditors in the median case.[18]

Most Chapter 11s terminate in dismissal or conversion to Chapter 7. The IL study found that, among firms with debt under $2 million, dismissal or conversion occurred in 77% of cases filed during 1998 and 66% of cases filed during 2006.[19] Similarly, the Multi-District study found dismissal or conversion in 70% of cases filed in 1994 and 67% of those filed in 2002.[20] These patterns are consonant with those reported by the National Bankruptcy Review Commission, which observed that "only a small fraction of the Chapter 11 cases filed nationwide end in confirmation of a plan of reorganization."[21] Failure to reach confirmation, however, is not necessarily an indicator of failure. A "successful" Chapter 11 could culminate in dismissal because the debtor has resolved its problems or has found a buyer.[22]

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[15] Robert M. Lawless & Steven Ferris, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. Pitt. L. Rev. 629, 651 (1999-2000).

[16] *See, e.g.*, Melanie Rovner Cohen & Joanna L. Challacombe, *Assignment for the Benefit of Creditors—Contemporary Alternatives for Corporations*, 2 DePaul Bus. L. J. 269, 270 (1990) ("In contrast to a Chapter 7 liquidation under the Bankruptcy Code, an assignment [for the benefit of creditors (ABC)] is generally more efficient, less costly, of shorter duration, more successful in terms of the value received for the assts and amounts paid to creditors and more tailored to the needs of debtors and their creditors."); David S. Kupetz, *Assignment for the Benefit of Creditors: Advantageous Vehicle for Selling and Acquiring Distressed Enterprises*, 6 J. Private Equity 16, 18 (2003) ("Compared to bankruptcy liquidation, assignments may involve a faster and more flexible liquidation process."); Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High-Tech Firms*, 82 Wash. U. L. Q. 1375, 1392-93 (2004) (concluding, based on interviews with practitioners, that "the net cost of the [ABC] process seems to be less than a bankruptcy proceeding"); Bruce C. Scalambrino, *Representing a Creditor in an Assignment for the Benefit of Creditors*, 92 Ill. Bar J. 263 (2004) (explaining that under Illinois law, "ABCs take less time than bankruptcy and require less in the way of court intervention and approval, which can mean lower professional fees for debtors.").

[17] Baird, Bris & Zhu, *supra* note 2, at Table 5.

[18] Robert M. Lawless, et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. Ill. L. Rev. 847, 863 (1994).

[19] Morrison, *Small Business*, *supra* note 1, at 79.

[20] Warren & Westbrook, *Success*, *supra* note 3, at 615.

[21] NBRC Report, *supra* note 6, at 610.

[22] Warren & Westbrook, *Success*, *supra* note 3, at 610-11. The IL Study found that about 17% of dismissals involved debtors that had undergone a going-concern sale or had hammered out an agreement

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Most dismissals and conversions occur early in the case, pointing to quick decision-making by the judge. In the IL study, 70% of dismissals and conversions occurred within the first 6 months of the case; 44% occurred within three months.[23] That study also marshaled evidence showing that judges were adept in distinguishing viable and non-viable firms.[24] Consistent evidence is presented in the Multi-District study, which finds that the probability of confirmation was 47% among firms that avoided dismissal or conversion during the first 6 months. The probability rose to 67% among those that avoided those outcomes during the first 12 months. Judges "pushed the losers out early."[25]

Debtor in possession (DIP) financing appears uncommon. To our knowledge, the best available evidence is from a study of small business filings between 1986 and 1994 in the Northern District of Georgia.[26] That study found DIP financing (new loans or lines of credit that must be approved by the court) in 10 percent of Chapter 11s. The financing was rarely provided by a bank; 95 percent of loans were extended by suppliers with secured prepetition claims. On the other hand, the authors did not investigate the frequency and terms of cash collateral orders based on prepetition credit relationships, which can serve as a substitute for DIP loans and can subject debtors to the kinds of control often seen in DIP loans.

Small businesses make up the vast majority of Chapter 11 filings. The IL study found that 75 percent of debtors had debt under $2 million and 77 percent had fewer than 20 employees.[27] Similar statistics are reported in the Multi-District Study. The NY/AZ Study found that, among confirmed Chapter 11s, median asset value was about $1.2 million.[28] Likewise, the National Bankruptcy Review Commission surveyed 1995-97 data from six districts and found that that 72 percent of debtors had debt under $2 million.[29]

Many Chapter 11s involve businesses with little measurable value as a going concern relative to liquidation. Value as a going concern typically stems from specialized assets. The IL Study found that at most 5.5 percent of the median firm's assets were specialized. Excluding restaurants, the percentage falls to 2.2. These percentages characterize firms with confirmed plans as well as those whose cases were dismissed or converted.[30]

Chapter 11s can function as a "waiting period" for serial entrepreneurs as they consider their next ventures and resolve personal liability for business debts. The IL Study found that, among cases that were dismissed or converted, 70 percent of owner-managers went on to start

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with key creditors. Morrison, *supra* note 4, at 390 tab. 4. Another 23% survived more than one year after the case was dismissed. *Id.*, at 291 tab. 5.

[23] Morrison, *Continuation Bias*, *supra* note 1, at 391.

[24] *Id.*, at 441.

[25] Warren & Westbrook, *Success*, *supra* note 3,at 621.

[26] Jocelyn Evans and Timothy Koch, *Surviving Chapter 11: Why Small Firms Prefer Supplier Financing*, 31 J. Econ. & Fin. 186, 191 (2007).

[27] These statistics were computed for this proposal.

[28] Bris, Welch & Zhu, *supra* note 2, at 1258.

[29] NATIONAL BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 631 (1997) (Hereinafter "NBRC Report").

[30] *Id.* at 2332.

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new businesses or continued running other, non-bankrupt businesses. 85 percent of the owner-managers had founded a separate business in the past or went on to start another after the case was dismissed or converted.[31] This may be unsurprising because entrepreneurs are highly unlikely to exit self-employment once they have owned businesses for several years.[32]

Tax claims and personal guarantees are ubiquitous in small Chapter 11 cases. The IL Study, for example, found that the owner-manager was personally liable for business debts in 85 percent of the cases, due to personal guarantees (56 percent of cases) or liability for trust fund taxes (61 percent).[33] Another study surveyed owners of small businesses that filed for bankruptcy in the Central District of California (San Fernando Valley Division) during 2004 and 2005.[34] Thirteen percent of respondents stated that tax liabilities were a cause of their bankruptcy filings.

Unsecured creditors' committees are rarely formed in small Chapter 11 cases. The IL Study found unsecured creditors' committees in only 3% of cases in which business debts were less than $2 million (2% in 1998, 6% in 2006).[35] The percentage rises to about 8% in cases reaching plan confirmation. By contrast, among firms with debt greater than $2 million, a committee was formed in 33% of the cases. Another study reports similar statistics based on a quasi-random sample of cases throughout the United States.[36] It finds a committee in 19 percent of cases generally (median debt equal to $1.2 million) and in 67 percent of cases involving large publicly-traded and privately-held firms (median debt equal to $50.2 million). Similar statistics were reported by the National Bankruptcy Review Commission.[37]

BAPCPA appears to have placed additional demands on the cash flow of Chapter 11 debtors. Sections 366(b), (c), and 503(b)(9) of the Bankruptcy Code now require the debtor to deposit cash sufficient to offer "adequate assurance" to utility suppliers and to give administrative expense priority to claims for goods supplied within 20 days of the bankruptcy petition. Although no empirical work has studied these sections yet, they likely impose larger burdens on small businesses than large firms because small businesses appear to face greater borrowing constraints.[38] Put differently, Sections 366(b) and 503(b)(9) increase the cost of

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[31] Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2337-40.

[32] *See, e.g.*, David S. Evans & Linda S. Leighton, *Some Empirical Aspects of Entrepreneurship*, 79 Am. Econ. Rev. 519 (1989) (studying 1966-81 data from the National Longitudinal Study of Youth and finding that the probability of exiting self-employment falls to zero after eleven years of owning a business).

[33] Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2362 tab. 17.

[34] Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, *supra* note 9, at 201.

[35] These statistics were computed for this proposal.

[36] Stephen Lubben, *Corporate Reorganization and Professional Fees*, 82 Am. Bankr. L. J. 77, 93-95 (2008).

[37] NBRC Report at 642.

[38] William M. Gentry & Glenn R. Hubbard, *Entrepreneurship and Household Saving*, 4 Adv. in Econ. Anal. & Policy, article 8 (2004), available at http://www.bepress.com/bejeap/advances/vol4/iss1/art8. *But compare* Erik Hurst & Annamaria Lusardi, *Liquidity Constraints, Household Wealth, and Entrepreneurship*, 112 J. Pol. Econ. 319 (2004) (doubting the importance of liquidity constraints for small businesses) *with* Robert W. Fairlie & Harry A. Krashinski, *Liquidity Constraints, Household Wealth, and*

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Chapter 11 by forcing a small business to generate sufficient cash flow to cover these requirements immediately.

B. Fundamental problems in small business Chapter 11s

The foregoing statistical patterns suggest that when a small business attempts reorganization, these problems loom large:

1. **Excessive Secured Creditor Influence.** Due to the small stakes for unsecured creditors, and the rarity of creditors' committees, secured creditors have excessive influence.
2. **Monitoring Deficits**. Without active involvement from unsecured creditors, it can be difficult for a judge to assess whether the firm is a viable candidate for reorganization. The judge must rely heavily on the U.S. Trustee or bankruptcy administrator, but he or she is primarily concerned about the debtor's compliance with procedural requirements. Because around two-thirds of all cases end in dismissal or conversion, one of the judge's most important jobs is to "filter out" non-viable cases as quickly as possible. Although judges have developed tools for doing this, the success of these tools likely depends on the amount of time and effort that judges can devote to monitoring and supervising cases, something the 1978 Code discourages.[39]
3. **High Costs**. Administrative costs consume a significant percentage of firm value. These costs may deter distressed businesses, the majority of which use non-bankruptcy procedures (negotiation with creditors, assignments for the benefit of creditors, etc.) to resolve financial distress.
4. **Obstacles to Reorganization**. BAPCPA's new requirements with respect to administrative expenses and adequate assurance effectively tax the cash flow of cash-strapped businesses, undermining chances for successful reorganization.

To be sure, the first three of these issues are not new. Monitoring Deficits and High Costs in particular were a concern of the National Bankruptcy Review Commission, which was created by Congress in 1994 to study the Bankruptcy Code.[40] With respect to the first issue, the Commission recommended, and BAPCPA adopted, various measures to give the U.S. Trustee greater power to monitor small business cases and to increase the information available to the court and Trustee. For example, the U.S. Trustee is now instructed to investigate the debtor's viability at the outset of the case,[41] and the debtor is instructed to submit periodic financial

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Entrepreneurship Revisited, (IZA Discussion Paper No. 2201 2006), available at http://ssrn.com/abstract=920640 (challenging the work of Hurst & Lusardi).

[39] *See, e.g.*, Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 Am. Bankr. L.J. 431, 4333-35 (1995); Dennis S. Meir & Theodore Brown, Jr., *Representing Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 217, 217 (1982).

[40] The commission's history is discussed at this website: http://govinfo.library.unt.edu/nbrc/facts.html.

[41] 28 U.S.C. § 586(a)(7).

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reports and schedules, attend all meetings, timely pay taxes, and maintain insurance.[42] Although BAPCPA extended the exclusivity period (from 100 to 180 days[43]) and deadline for submitting a plan (from 160 days to 300 days[44])—contrary to the Commission's recommendation[45]—the Act imposed a new 45-day deadline for achieving plan confirmation.[46] These changes increased the obligations on small businesses but did not necessarily create the conditions to facilitate reorganization. Furthermore, BAPCPA reduced judges' discretion in determining whether to dismiss or convert chapter 11 cases even though the empirical research reviewed earlier suggests that courts had good track records of sorting viable and nonviable cases.[47]

The National Bankruptcy Review Commission addressed High Costs to some extent by recommending that disclosure statements be simplified or eliminated in small business cases and that courts promulgate standardized disclosure statements and reorganization plans. The first recommendation found its way into BAPCPA,[48] and there are now Official Forms for small business plans and disclosure statements.[49] Although this was a useful step, it did not address the many other ways in which Chapter 11 produces considerable administrative costs in small business cases.

II. Chapter 12 is a solution to the problems facing small business reorganizations

A promising fix to the problems of reorganizing small businesses already exists in the Bankruptcy Code. That approach, chapter 12, was enacted in response to a small business problem not unlike the one we face today. During the early 1980's (and still today), farms were small businesses, often owned by members of a single family. Farm product prices were falling because of technological advances, improved transportation and mechanization and the growth of corporate farms.[50] The value of farmland was falling, especially in the Midwest. The lenders to farmers were in crisis for many reasons, including an avalanche of failed or failing banks that reduced the availability of credit. Lending to small business farmers dried up. Farmers couldn't put in crops and soon could not make their mortgage payments.

Many small farm businesses attempted to reorganize in Chapter 11 cases.[51]These cases inevitably failed for several reasons.[52] Small farmers often could not afford the cost of the

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[42] 11 U.S.C. §§ 308, 1116.
[43] § 1121(e)(1).
[44] § 1121(e)(2).
[45] NBRC Report, at 64-65.
[46] 11 U.S.C. § 1129(e).
[47] 11 U.S.C. § 1112(b).
[48] § 1125(f).
[49] *See* http://www.uscourts.gov/bkforms/bankruptcy_forms.html#official.
[50] This paragraph draws on the discussion in Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 484-86 (2005); Steven Shapiro, Note, *An Analysis of the Family Farmer Bankruptcy Act of 1986*, 15 Hofstra L. Rev. 353, 360-62 (1987).
[51] Shapiro, *supra* note 50, at 364.
[52] This paragraph draws from Hon. A. Thomas Small, *Chapter 12-The Family Farmer Bankruptcy Act of 1986*, 1987 Norton Ann. Surv. Bankr. L. 1.

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process.[53] Farm lenders lacked flexibility to negotiate outcomes that would work for small farm reorganizations. Lenders secured by farmland were often undersecured (that is, their debt exceeded the value of the property) and could vote the unsecured portion of their claims to defeat confirmation of any plan. Farmers in Chapter 11 could not sell part of their farms to reduce the operation to a size that was viable without the consent of their lenders.[54] Chapter 13 was rarely a useful alternative because the debt limits were too low,[55] only individuals were eligible[56] and the tools for management of secured debt were not robust enough to help farmers.[57]

At the urging of Senator Grassley (R. Iowa) and the late Congressman Mike Synar (D. Okla.), Chapter 12 of the Bankruptcy Code was hatched to address the reorganization needs of farm businesses. The instructions from Synar and Grassley were simple: draft a new reorganization chapter accessible for farm businesses up to a certain size with ownership limited to the members of an extended family without the disclosure, voting and other complications of Chapter 11. The basic rights of creditors in a Chapter 11 case must be retained. Unsecured creditors must be paid at least what they would receive in a liquidation of assets under Chapter 7. Secured creditors must receive surrender of their collateral or the debtor must pay the "present value" of that collateral (meaning, with interest) through the plan. In recognition of the long-term nature of loans secured by farmland and equipment, farm businesses must be able to pay secured creditors (with interest) over an appropriate period of years. Legislation creating Chapter 12—The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986[58]—was signed into law by President Reagan on October 27, 1986. The law became effective November 26, 1986.[59]

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[53] H.R. Conf. Rep. 99-958 at 5249, 1986 USCCAN 5246 (Oct. 2, 1986) ("Most family farmers have too much debt to qualify as debtors under Chapter 13 and are thus limited to relief under Chapter 11. Unfortunately, many family farmers have found Chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive and, in too many cases, unworkable.").

[54] *Id.* ("Most family farm reorganizations, to be successful, will involve the sale of unnecessary property. [Section 1206] . . . allows Chapter 12 debtors to scale down the size of their farming operations by selling unnecessary property. This section modifies 11 USC 363(f) to allow family farmers to sell assets not needed for the reorganization prior to confirmation . . . the creditor's interest . . . would attach to the proceeds of the sale.").

[55] *See* 11 U.S.C. § 109(e) (secured and unsecured debt limitations for Chapter 13). *See also* Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 486 (2005) ("debt limits allowed under Chapter 13 were too low for most family farmers").

[56] § 109(e) ("Only an individual with regular income . . . may be a debtor under chapter 13 of this title."). "Individual with regular income" is defined in § 101(30) to mean "an individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title[.]"

[57] In Chapter 13, farmers could not modify real estate secured loans and were limited in ability to sell property. *See, e.g.*, § 1322(b)(2).

[58] Pub. L. No. 99-544, 100 Stat. 3105 (1986).

[59] Pub. L. No. 99-544, § 302(a).

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A. Comparing Chapters 11 and 12

Table 1 sets out key differences between small business reorganization under Chapters 11 and 12. Perhaps the most important differences involve the appointment of a standing trustee, tighter deadline for submitting a plan of reorganization, lower repayment obligations, and more flexible treatment of administrative expenses in Chapter 12.

Although the debtor remains in control of his or her business regardless of the Chapter, only Chapter 12 mandates the appointment of a standing trustee in every case.[60] The trustee is charged with responsibility to monitor the case and to be heard at any hearing involving the valuation or sale of assets or the confirmation or modification of a plan.[61] The standing trustee ensures that the court receives an unbiased, continuous flow of information about the firm's viability.

Chapter 12 also imposes stricter deadlines on the submission of plan of reorganization: a plan must be submitted within 90 days[62] and either confirmed or rejected no more than 45 days later.[63] This contrasts with the much longer deadlines (300 days for plan submission) under Chapter 11's small business provisions.[64] The strict deadlines in Chapter 12 prevent firms from using the Code solely as a means for thwarting creditor collection efforts.

In Chapter 12, family farmers and fishermen can retain ownership interests in their businesses even if they cannot pay creditors in full. This outcome is prohibited by Chapter 11's absolute priority rule, but permitted under Chapter 12 because unsecured creditors are instead entitled to all of a Chapter 12 debtor's disposable income for up to five years[65] following plan confirmation and must receive at least what they would be paid in a Chapter 7 liquidation.[66] At the end of the repayment period, any unpaid unsecured claims are discharged. (Secured claims must be repaid in full, but payments can exceed the five year period of the Chapter 12 plan[67]). These repayment rules ensure that a family farmer or fisherman does not engage in wasteful efforts to avoid bankruptcy for fear of losing ownership of the business. As long as secured creditors are repaid in full and unsecured creditors receive all of the business's disposable income for up to five years, the farmer or fisherman can retain ownership.

Finally, Chapter 12 offers debtors greater flexibility in repaying administrative expenses, such as attorney fees and the claims of suppliers who delivered goods within 20 days prior to the bankruptcy petition.[68] Chapter 11 requires immediate payment in cash on the date of confirmation (unless the claimants agree to different treatment).[69] Because family farmers and

[60] 11 U.S.C. § 1202.
[61] § 1202(b).
[62] § 1221.
[63] § 1224.
[64] §§ 1121(e)(2) (300 day deadline for submitting plan), 1129(e) (45 day deadline for confirmation hearing).
[65] §§ 1222(c), 1225(b).
[66] § 1225(a)(4).
[67] § 1225(a)(5).
[68] § 1222(a)(2).
[69] § 1129(a)(9).

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fisherman, like all small businesses, are often cash-strapped, the Chapter 11 rule creates barriers to confirming a plan. Chapter 12 eliminates this barrier by permitting gradual repayment of attorney fees and other administrative expenses over time.

Since its enactment in 1986, thousands of family farmers and fishermen have reorganized under Chapter 12.[70] Figure 1 plots the number of Chapter 12 filings since the law's enactment. Although Chapter 12 began as an emergency measure, Congress made it a permanent part of the Code—and made it available to family fishermen as well as farmers—in the Bankruptcy Abuse and Consumer Protection Act of 2005.[71] Although the law has not been used frequently in recent years, this could be seen as a measure of its success.[72] Over time, lenders and farm owners have come to understand what happens in a Chapter 12 case; many small farm businesses have been able to reorganize without resorting to bankruptcy.

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[70] *See, e.g.*, Jonathan K. Van Patten, *Chapter 12 in the Courts*, 38 S.D.L.R. 52, 54-55 (1993).

[71] BAPCPA made Chapter 12 permanent as of July 1, 2005, to coincide with expiration of the 2004 extension.

[72] *See, e.g.*, Katherine M. Porter, *Phantom Farmers: Chapter 12 of the Bankruptcy Code*, 70 AM. BANKR. L.J. 729, 743 (2005) ("Chapter 12 may have its greatest effect in the shadow of bankruptcy. The mere existence of Chapter 12 influences a creditor's willingness to engage in loan workouts because the creditor must evaluate its recovery if the debtor filed bankruptcy. By defining the boundaries of what each party's rights will be in bankruptcy, Chapter 12 provides a firm structure against which debtors and creditors can negotiate in restructuring loans. All of bankruptcy law has this potential, but Chapter 12 offers a particularly powerful incentive for creditors to reach a non-bankruptcy resolution. Compared to Chapter 11, a creditor in a Chapter 12 case has relatively few tools at its disposal to derail a debtor's effort to reorganize. A survey of attorneys who represented distressed farmers or agricultural creditors found that between one-third and half of disputes were negotiated successfully. Attorneys cited the existence of Chapter 12 as an 'influencing factor in 58.06 percent of these successful negotiations.' The 'shadow' effect of Chapter 12 is difficult to measure exactly but Chapter 12 appears to provide substantial assistance to farmers in obtaining a forbearance or write down of their debt even if no bankruptcy case is ever filed.") (footnotes omitted).

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Table 1: Comparison of Chapters 11 and 12

Issue	Chapter 11 (small business provisions)	Chapter 12
Eligibility	Any individual or business described in 109(d).	Any family farmer or fisherman with regular annual income, including a corporation
Involuntary filings permitted	Yes	No
Debtor remains in possession of business?	Yes	Yes
Unsecured creditors committee can be formed	Yes	No
Standing trustee	No	Yes
Debtor has exclusive right to file a plan of reorganization	No: debtor has exclusivity only for the first 180 days	Yes
Deadline for filing plan of reorganization	Yes: 300 days	Yes: 90 days
Maximum term of plan	No	Yes: five years
Creditors vote on the plan	Yes	No: creditors may object to a plan; the court rules on the objections
Creditors entitled to full payment before owner receives value	Yes, except in cases filed by individual debtors	No: creditors are entitled to all of debtor's projected disposable income for up to five years.
Administrative expenses must be paid in full at plan confirmation	Yes	No: deferred cash payments are acceptable
Secured debt repayments can exceed the term of the plan	No	Yes
Secured claims can be modified, including reducing secured debts to the value of the collateral	Yes, except for home mortgages in individual debtor cases	Yes
Plan must pay creditors at least what they would receive in liquidation	Yes	Yes

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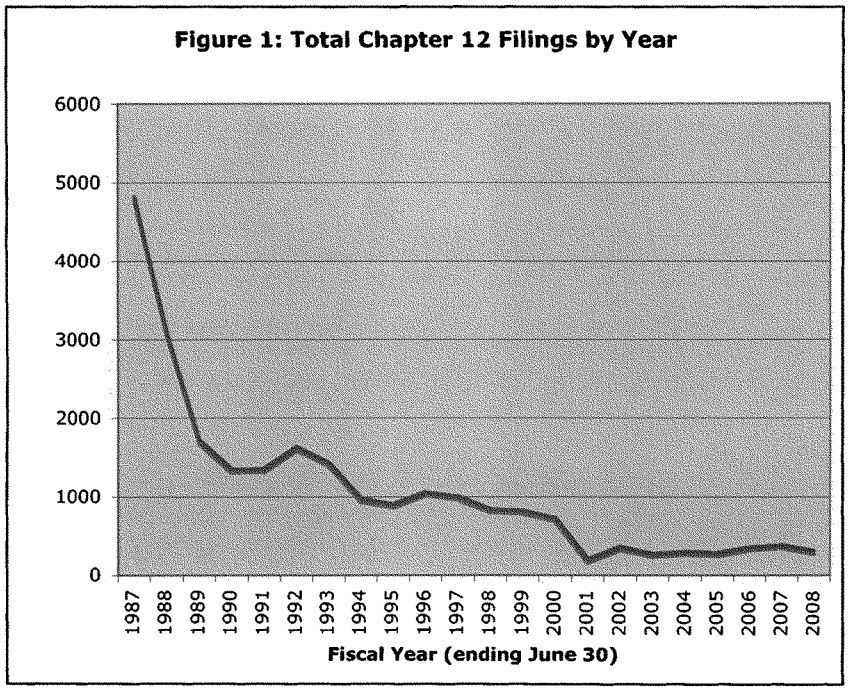

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B. Making Chapter 12 available to small businesses generally

Family farmers and fishermen are small businesses, and Chapter 12 has proven to be a viable, low-cost reorganization procedure. Chapter 12 would be equally effective in addressing the needs of small businesses generally. As the foregoing discussion has shown, it addresses the key problems facing small business corporations seeking to reorganize:

1. **Excessive Secured Creditor Influence:** The influence of secured creditors is moderated by the presence of a standing trustee and the debtor's ability to confirm a reorganization plan without a creditor vote.

2. **Monitoring Deficits**. The standing trustee provides a continuous, unbiased source of information about the debtor's viability. In a small business case, the trustee "would give impartial oversight of the debtor's operations, examine the debtor's affairs, make recommendations concerning confirmation of the plan, mediate disputes, monitor compliance for three years after confirmation, and carry out the terms of the plan if the debtor does not."[73]

3. **High Costs**. Administrative costs are reduced by tight deadlines for submitting plans of reorganization, the elimination of big-case procedures such as the Chapter 11 disclosure statement, and the court's ready access to information about the debtor's viability.

4. **Obstacles to Reorganization**. Chapter 12 imposes fewer demands on the debtor's cash flow by allowing administrative expenses to be paid over time after plan confirmation.

A relatively small number of amendments would be necessary to make Chapter 12 available to small businesses generally. The following paragraphs discuss the amendments. In an Appendix, we present draft legislation.

Eligibility: In addition to family farmers and fishermen, only small business enterprises should be eligible to use Chapter 12. We propose making Chapter 12 available to a "small business enterprise" ("SBE"), defined as a corporate or non-corporate person—other than a family farmer or family fisherman—who is engaged in a business or commercial activity and has total debts not exceeding $10 million, provided at least fifty percent of the debt arises from the person's business or commercial activities. This definition would appear in new Section 101(51E). We would amend Section 109(f) to state that a SBE is eligible to be a debtor under Chapter 12 only if the SBE has regular income. (A technical amendment to Section 104(a) would be needed to periodically adjust the $10 million threshold for inflation.)

Our proposed definition of a SBE is broader than the Code's current definition of a "small business debtor," which includes any business with total debt not exceeding $2 million.

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[73] Small, *If You Fix It, They Will Come*, *supra* note 3, at 983. *See also*, Hon. A. Thomas Small, *Paying the Piper: Rethinking Professional Compensation In Bankruptcy—Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305 (1993); Hon. A. Thomas Small, *Suggestions for the National Bankruptcy Review Commission and Congress*, 4 Am. Bankr. Inst. L. Rev. 550 (1996).

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We do not propose changing the definition of a small business debtor. A SBE should remain free to use Chapter 11 if that is a preferable option. And if it qualifies as a small business debtor, it will be subject to the special rules governing those businesses in Chapter 11.

Rights and powers of the debtor: Many small businesses enter bankruptcy with debts to their attorneys and accountants. Section 327(a) requires that the debtor's attorney or accountant must be "disinterested" during the pendency of the case. Section § 101(14), in turn, states that a creditor is not a disinterested person. It would be unduly burdensome to force small businesses to find new attorneys or accountants after commencing a Chapter 12 case. We therefore propose amending Section 1203 to declare that a professional person is not disqualified from employment solely because he or she has a prepetition claim. This amendment would apply to all debtors in a Chapter 12 case, not just SBEs.

Reporting requirements: SBEs should be subject to most of the same reporting requirements in Chapter 12 that are currently applicable to small business debtors in Chapter 11. We therefore propose adding new Section 1209, which largely replicates the requirements of § 308 and § 1116. In order to clarify that 1209 captures the full reporting duties of a SBE, we propose amending § 308 to apply only in small business Chapter 11 cases.

Discharge: The date on which a debtor obtains a discharge varies by Chapter and debtor. In cases under Chapter 12, all debtors typically receive a discharge upon completion of payments,[74] but may also receive a discharge before completing all payments if creditors have already been paid what they would receive in a liquidation and if the failure to complete payments is due to circumstances for which the debtor should not justly be held accountable.[75] In cases under Chapter 11, the rule varies by debtor. Corporate debtors receive discharge at confirmation.[76] Among *individual* debtors, three rules govern discharge: a court can grant discharge (i) upon completion of plan payments,[77] (ii) prior to completion of plan payments if creditors have already received at least what they would expect in a liquidation and modification of the plan is not practicable,[78] or (iii) at confirmation or any other date prior to completion of plan payments if the court determines—for cause and after notice and hearing—that an earlier date for discharge is appropriate.[79]

We propose applying the Chapter 11 individual debtor rules to SBEs in Chapter 12. Discharge should typically be available after the SBE completes plan payments, but the judge should have discretion to grant an earlier discharge *either* for cause *or* because creditors have already received their liquidation rights and circumstances beyond the debtor's control prevent further payments. Although it would be the exceptional case in which a SBE merits discharge at confirmation, the court should have authority to grant such a discharge.

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[74] § 1228(a).
[75] § 1228(b).
[76] § 1141(c).
[77] § 1141(d)(5)(A).
[78] § 1141(d)(5)(B).
[79] § 1141(d)(5)(A). *See also* In re *Sheridan*, 391 B.R. 287 (Bankr. E.D.N.C. 2008).

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C. Potential Controversies

Several aspects of Chapter 12 merit further discussion: treatment of residential mortgages, creditor voting, creditors' committees, and appointment of standing trustees.

Residential mortgages. Chapter 12 permits debtors to restructure secured debt, including real estate mortgages that are secured by the debtor's residence.[80] The value of the secured claim can be reduced to the value of the collateral. That value must be paid over time with interest, but the difference between the original secured debt and the value of the collateral—the deficiency—is treated as an unsecured claim. Although Chapter 12 debtors can therefore "cram down" a home mortgage, this right would be available only to SBEs that own residences. Thus, a sole proprietor would be able to cram down a residential mortgage. That power is already possessed by family farmers and fishermen.[81] Similarly, a corporate SBE could cram down a home mortgage, provided the corporation owned the residence. This power too is already possessed by any corporation or partnership that files a Chapter 11 case.[82]

It is important to emphasize, however, that most real estate secured debts, such as residential home mortgages, would not find their way into Chapter 12. Few residences are owned by the types of small businesses—enterprises that are engaged in commerce or business and whose debts are primarily business-related—that would be newly eligible for Chapter 12. Ordinary wage earners would not be eligible for an expanded Chapter 12.

Voting. Creditors have the right to vote on small business chapter 11 plans today but would not have the right to vote on small business plans in chapter 12. This is an important change, but is not a significant concern for the following reasons. First, small businesses already use Chapter 13, which does not permit creditor voting.[83] Second, it is the experience of bankruptcy professionals everywhere that creditors don't participate in small business Chapter 11 cases even though they have the right to vote on plans.[84] For the most part, small business cases simply aren't large enough to command the attention of individual creditors. Voting is a possibility but rarely a reality in small business Chapter 11 cases.

Furthermore, voting is not essential to protect unsecured creditors because chapter 12 expressly requires debtors to pay creditors in accordance with specified standards. With respect to unsecured creditors, Chapter 12 contains a "those who can pay should pay" provision.[85] Upon appropriate objection, every Chapter 12 debtor must commit all projected disposable income to payments to creditors for no less than three years.[86]

Unsecured creditors committee. Chapter 12 does not permit formation of official creditors' committees, but this change will impose few if any burdens on unsecured creditors. As

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[80] § 1222(b)(9) and (c).
[81] *Id.*
[82] § 1123(b)(5).
[83] § 1325.
[84] *See* Small, *If You Fix It, They Will Come*, *supra* note 3, at 983-84.
[85] § 1225(b).
[86] § 1225(b)(1)(B).

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noted above,[87] these committees are rarely formed in small business cases. Instead of committees, Chapter 12 relies on the standing trustee to protect the rights of unsecured creditors. Because a trustee is appointed in every Chapter 12 case, but a committee is rarely assembled in a Chapter 11 case, unsecured creditors will generally enjoy greater protection in Chapter 12 cases.

Trustee caseload and compensation. As SBEs begin using Chapter 12, the caseload of Chapter 12 trustees will increase dramatically. There were only 345 Chapter 12 filings but nearly 10,000 Chapter 11 cases during calendar year 2008.[88] The bulk of Chapter 11 cases are filed by small businesses.[89] Again, this proposal would not preclude SBEs from filing Chapter 11 petitions. However, if most of these businesses choose Chapter 12 instead of Chapter 11, Chapter 12 trustees will see a much heavier docket. This will necessitate the appointment of additional trustees and the hiring of staff to assist trustees in evaluating cases and providing the counseling necessary to move a small business through Chapter 12 quickly.

Respectfully submitted,

Small Business Working Group
Hon. A. Thomas Small, Co-Chair
Prof. Edward Morrison, Co-Chair
Hon. Keith Lundin
Prof. Melissa B. Jacoby
Richardo I. Kilpatrick, Esq.
David Lander, Esq.
Prof. Alan N. Resnick

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[87] See text accompanying notes 35-36, *supra*.

[88] These statistics are drawn from the website of the Administrative Office of the U.S. Courts. *See* http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm.

[89] See text accompanying footnotes 27-29, *supra*.

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APPENDIX

PROPOSED AMENDMENTS TO THE BANKRUPTCY CODE RELATING TO CHAPTER 12 CASES FOR SMALL BUSINESS ENTERPRISES

Change the title of Chapter 12 as follows:

Chapter 12. Adjustment of Debts of a Family Farmer ~~or Fisherman~~ , Family Fisherman, or Small Business Enterprise with Regular Annual Income

* * * *

Section 101. Definitions

* * * *

(51E) The term "small business enterprise" means a person (excluding a family farmer or family fisherman) engaged in commercial or business activities if –

(a) the person has aggregate noncontingent, liquidated secured and unsecured debts as of the order for relief in an amount not more than $10,000,000 (excluding debts owed to 1 or more affiliates or insiders); and

(b) at least 50 percent of such debts arose from the person's commercial or business activities (determined without including, if the person is an individual, any debt for the personal residence of the person or the person and spouse, unless such debt arose from the person's commercial or business activities).

* * * *

Section 104. Adjustment of Dollar Amounts

(a) On April 1, 1998, and at each 3-year interval ending on April 1 thereafter, each dollar amount in effect under sections 101(3), 101(18), 101(19A), 101(51D), 101(51E), 109(e), 303(b), 507(a), 522(d), 522(f)(3), and 522(f)(4), 522(n), 522(p), 522(q), 523(a)(2)(C), 541(b), 547(c)(9), 707(b), 1322(d), 1325(b) and 1326(b)(3) of this title and section 1409(b) of title 28 immediately before such April 1 shall be adjusted—

(1) to reflect the change in the Consumer Price Index for All Urban Consumers, published by the Department of Labor, for the most recent 3-year period ending immediately before January 1 preceding such April 1, and

(2) to round to the nearest $25 the dollar amount that represents such change.

(b) Not later than March 1, 1998, and at each 3-year interval ending on March 1 thereafter, the Judicial Conference of the United States shall publish in the Federal Register the dollar amounts that will become effective on such April 1 under sections 101(3), 101(18), 101(19A), 101(51D), 101(51E), 109(e), 303(b), 507(a), 522(d),

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522(f)(3), and 522(f)(4), 522(n), 522(p), 522(q), 523(a)(2)(C), 541(b), 547(c)(9), 707(b), 1322(d), 1325(b) and 1326(b)(3) of this title and section 1409(b) of title 28.

(c) Adjustments made in accordance with paragraph (1) shall not apply with respect to cases commenced before the date of such adjustments.

* * * *

Section 109. Who May Be a Debtor

* * * *

(f) Only a family farmer, ~~or~~ family fisherman, or small business enterprise with regular annual income may be a debtor under chapter 12 of this title.

* * * *

Section 308. Debtor Reporting Requirements

(a) For purposes of this section, the term "profitability" means, with respect to a debtor, the amount of money that the debtor has earned or lost during current and recent fiscal periods.

(b) In a small business case, the debtor ~~A small business debtor~~ shall file periodic financial and other reports containing information including—

(1) the debtor's profitability;
(2) reasonable approximations of the debtor's projected cash receipts and cash disbursements over a reasonable period;
(3) comparisons of actual cash receipts and disbursements with projections in prior reports;
(4) (A) whether the debtor is—
(i) in compliance in all material respects with postpetition requirements imposed by this title and the Federal Rules of Bankruptcy Procedure; and
(ii) timely filing tax returns and other required government filings and paying taxes and other administrative expenses when due;
(B) if the debtor is not in compliance with the requirements referred to in subparagraph (A)(i) or filing tax returns and other required government filings and making the payments referred to in subparagraph (A)(ii), what the failures are and how, at what cost, and when the debtor intends to remedy such failures; and
(C) such other matters as are in the best interests of the debtor and creditors, and in the public interest in fair and efficient procedures under chapter 11 of this title.

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Section 1203. Rights and powers of debtor

(a) Subject to such limitations as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330, and powers, and shall perform all the functions and duties, except the duties specified in paragraphs (3) and (4) of section 1106(a), of a trustee serving in a case under chapter 11, including operating the debtor's farm, commercial fishing operation, or small business enterprise's business.

(b) Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because such person

(1) was employed by or represented the debtor before the commencement of the case; or
(2) is a creditor of the debtor.

* * * *

Section 1206. Sales free of interests

After notice and a hearing, in addition to the authorization contained in section 363(f), the trustee in a case under this chapter may sell property under section 363(b) and (c) free and clear of any interest in such property of an entity other than the estate if the property is farmland, farm equipment, or property used to carry out a commercial fishing operation (including a commercial fishing vessel) or used in connection with the business of a small business enterprise, except that the proceeds of such sale shall be subject to such interest.

* * * *

Section 1209. Duties of a Debtor in a Case of a Small Business Enterprise

In a case in which the debtor is a small business enterprise, the debtor, in addition to the duties provided in this title and as otherwise required by law, shall—

(a) file with the voluntary petition --

(1) its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return; or

(2) a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed;

(b) attend, through its senior management personnel and counsel, any meetings scheduled by the court or the United States trustee, including initial debtor

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interviews and scheduling conferences, and meetings of creditors convened under section 341, unless the court, after notice and a hearing, orders otherwise;
(c) timely file all schedules and statements of financial affairs, unless the court, after notice and a hearing, grants an extension;
(d) file all postpetition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court;
(e) subject to section 363(c)(2), maintain insurance customary and appropriate to the debtor's business;
(f) (1) timely file tax returns and other required government filings; and
(2) subject to section 363(c)(2), timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings being diligently prosecuted; and
(g) allow the United States trustee, or a designated representative of the United States trustee, to inspect the debtor's business premises, books, and records at reasonable times, after reasonable prior written notice, unless notice is waived by the debtor.
(h) file periodic financial and other reports containing information including –
(1) the amount of money that the debtor has earned or lost during the current and recent fiscal periods;
(2) reasonable approximations of the debtor's projected cash receipts and cash disbursements over a reasonable period;
(3) comparisons of actual cash receipts and disbursements with projections in prior reports;
(4) (A) whether the debtor is—
(i) in compliance in all material respects with postpetition requirements imposed by this title and the Federal Rules of Bankruptcy Procedure; and
(ii) timely filing tax returns and other required government filings and paying taxes and other administrative expenses when due; and
(B) if the debtor is not in compliance with the requirements referred to in subparagraph (A)(i) or filing tax returns and other required government filings and making the payments referred to in subparagraph (A)(ii), what the failures are and how, at what cost, and when the debtor intends to remedy such failures.

* * * *

Section 1228. Discharge

(a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan or, in a case in which the debtor is a small business enterprise, at such earlier time on or after the date on which the plan is confirmed as the court after notice and a hearing orders for cause, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are

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due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, other than payments to holders of allowed claims provided for under section 1222(b)(5) or 1222(b)(9) of this title, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan allowed under section 503 of this title or disallowed under section 502 of this title, except any debt—
(1) provided for under section 1222(b)(5) or 1222(b)(9) of this title; or
(2) of the kind specified in section 523(a) of this title.

* * * *

Effective Date; Application of Amendments [Non-Codified Provision]

(a) EFFECTIVE DATE – Except as provided in subsection (b) and (c), this Act and the amendments made by this Act shall take effect 30 days after the date of enactment of this Act.
(b) APPLICATION OF AMENDMENTS – The amendments made by this Act shall not apply with respect to cases commenced under title 11, United States Code, before the effective date of this Act.
(c) CONVERSION OF SMALL BUSINESS CASES TO CHAPTER 12 – Small business cases commenced under title 11, United States Code, before the effective date of this Act may not be converted to a case under chapter 12 of title 11 unless the debtor is a family farmer or family fisherman with regular annual income.

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Statement of

The Honorable Sheldon Whitehouse

United States Senator
Rhode Island
March 17, 2010

Committee on the Judiciary
Subcommittee on Administrative Oversight and the Courts
Hearing on "Could Bankruptcy Reform Help Preserve Small Business Jobs?" March 17, 2010
Statement of Senator Sheldon Whitehouse

The hearing will come to order.

While some economists may have declared the recession over, its painful aftermath – in the form of a prolonged period of unemployment – continues nationwide. The national unemployment rate stands at almost 10% and the situation is even worse in some areas: Senator Session's state of Alabama has an 11.1% unemployment rate and my state of Rhode Island ranks third nationwide at 12.7%. Job retention and preservation should be, and is, at the top of our legislative agenda.

Today we are going to explore changes to the Bankruptcy Code that would help small companies to reorganize and stay in business. The ideas we will discuss today are worthwhile to consider for two reasons: (1) small businesses account for over half of all jobs nationwide; and (2) unlike other job-preserving measures like tax cuts and government investment, bankruptcy reform can be accomplished with zero cost to the federal budget.

While small business bankruptcy reforms may prove a powerful tool in cutting job losses, the need for a new bankruptcy reorganization option has been clear for some time. Chapter 11 was designed for large, publicly-traded companies and doesn't work well for smaller companies for a number of reasons. First, Chapter 11 extinguishes equity so the debtor-owners exit the bankruptcy not owning their company anymore. A change in shareholders may not discourage big corporations from reorganizing, but for small businesses the corporate entity and its owner cannot be so easily disaggregated.

Second, small businesses often have a number of trade creditors and other unsecured creditors that do not participate in a Chapter 11 because their claims are too small. This failure to participate leaves the secured creditors steering the bankruptcy, often toward liquidation.

And finally, the Chapter 11 process is time-consuming and expensive and attorneys fees and other administrative costs often eat up so much of the firm's value that there is not enough left for the firm to emerge from bankruptcy as a going entity.

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The National Bankruptcy Conference has proposed addressing these three issues by opening up Chapter 12 – a process currently available only to family farms and fishermen – to a wider group of small businesses. I expect that Judge Small will discuss this proposal in his testimony today. I have reviewed the NBC's report and believe that they make a strong case for the Chapter 12 approach.

I want to stress however that I look forward to hearing the thoughts of all of the witnesses on possible small business bankruptcy reforms. It appears from the written testimony that each of you acknowledges that certain changes to bankruptcy law might help to preserve small business value and to save jobs.

As we discuss the NBC proposal, there are a number of variables about which I am interested in getting the witnesses' feedback. Is the proposed definition of "small business entity" appropriate? Should the reforms be made permanent or be enacted on a trial basis as Chapter 12 for family farms initially was?

Through it all, one thing is clear: Small businesses are the lifeblood of our economy, and they're hurting in today's economic climate. We should be considering all options, including reforms to our Bankruptcy Code, to help small business keep their doors open and keep their employees on the payroll.

I look forward to a lively discussion with our distinguished panel of witnesses:

Ed Mendenhall owned a fitness center in Warren, RI from 1996 to 2009. In his testimony, Mr. Mendenhall will describe his efforts to save his business. Mr. Mendenhall is a graduate of the University of Rhode Island and has an extensive background in personal training and fitness.

Chuck Bullock practices bankruptcy law in Detroit, Michigan, an area with no shortage of bankruptcies in recent years. He has represented small business debtors, and secured and unsecured creditors. A graduate of the University of Michigan and the University of Memphis School of Law, Mr. Bullock teaches bankruptcy at Cooley Law School.

Tom Small served as U.S. Bankruptcy Judge for the Eastern District of North Carolina from 1982 to 2009. He also served as President of the National Conference of Bankruptcy Judges and as a Board Member of the American Bankruptcy Institute. He holds degrees from Duke University and Wake Forrest University School of Law. Judge Small continues to be an active member of the National Bankruptcy Conference and serves as Co-Chair of its small business working group. Judge Small helped Senator Grassley to draft the original Chapter 12 back in the 1980s.

Joseph Mason is the Hermann Moyse/Louisiana Bankers Association Chair of Banking at the Louisiana State University and Senior Fellow at the Wharton School. Dr. Mason's academic research focuses primarily on investigating liquidity in thinly-traded assets and illiquid market conditions. A graduate of Arizona State University, he has an M.S. and Ph.D. from the University of Illinois.

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Thomas B. Bennett has been a United States Bankruptcy Judge for the Northern District of Alabama in Birmingham since 1995. For over fifteen years, he was a partner with the law firm of Bowles Rice McDavid Graff & Love PLLC and served as head of the firm's bankruptcy, creditors' rights and commercial litigation practice groups. Judge Bennett graduated from Girard College in Philadelphia, Pennsylvania in 1966 and received his undergraduate and graduate degrees in economics as well as his law degree from West Virginia University.