

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

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 Administration¹:

- 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 in 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

¹U.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 .

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 interest³:

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> .

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

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 million⁴;
- 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 Section 1112 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.

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

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 recommend 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 Report⁵:

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.

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.

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:

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 corporations⁷. 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!

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.