

Testimony of

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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 11 of 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

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.

**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

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:

...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

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

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.

*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

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

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., 15<sup>th</sup> 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

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

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.

## **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 Bluridge Farms, Inc., 93 B.R. 648, 656 (Bankr. S.D. Iowa 1988).

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

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 where 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

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

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.

Case Counts by Estimated Asset & Liability Codes

Assets	Liabilities										Total		
	A	B	C	D	E	F	G	H	I	J		7	8
A	564	115	393	234	517	154	46	99	48	74	-	-	2,244
B	22	57	149	56	59	10	3	14	4	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
8	-	-	-	-	-	-	-	-	-	-	-	-	84
Total	769	250	1,334	1,360	4,833	1,230	276	779	344	1,539	-	-	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	6,077	5,112	6,067	8,855	5,917
> 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	66	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	188	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	88	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	98	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	289	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	6	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	536	370	176	635	449	12	182
> 20,000,000	<= 30,000,000	185	114	71	218	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	67	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	16	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	> 100,000,000,000	1	-	1	-	-	-	-