

Ancillary Testimony of Joseph R. Mason

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

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“Could Bankruptcy Reform Help Preserve Small Business Jobs”

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.

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.