

SMALL BUSINESS CHAPTER 11s UNDER THE 2005 BANKRUPTCY AMENDMENTS

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Introduction

This outline focuses only on BAPCPA provisions specifically applicable to “small business cases” and “small business debtors” under the Bankruptcy Code (11 USC § 101(51) (C) and (D)). We refer you to “The New Rules of Bankruptcy for Small Business Debtors” written by George Singer of Lindquist & Vennum, PLLP (available online at www.lindquist.com, on the attorney page for George Singer as a White Paper) for a succinct summary of the small business provisions. For additional reading on the small business provisions, see “The Small Business Provisions of the 2005 Bankruptcy Amendments,” an article which appeared in the summer, 2005 edition of the American Bankruptcy Law Journal, by Thomas Carlson and Jennifer Hayes.

HISTORY

Before turning to the specific provisions of the new bankruptcy law regarding small business cases and small business debtors, it is helpful to an understanding of these provisions to first briefly review some history.

Bankruptcy Code of 1978

- Prior to 1978 business reorganizations were divided into four separate chapters under the former Bankruptcy Act.
- The Bankruptcy Code enacted in 1978 collapsed these chapters into the current Chapter 11.
- Over the years, there has been a fair amount of criticism leveled that Chapter 11 is too complex, expensive and slow for the majority of debtors.
- Many critics rejected the one size fits all approach of Chapter 11 under the Bankruptcy Code.

1994 Amendments

In 1994, the Bankruptcy Code was amended to define small business debtors.

- The test for small business debtors was based upon liabilities: an aggregate of \$2,000,000.
- However, treatment as a small business debtor was optional.
- If a debtor elected to be a small business debtor, the debtor could request that there be no creditors committee.
- The most significant restriction imposed upon a small business debtor under the 1994 amendments was a shortened period of exclusivity for filing a plan: the debtor had a 100 day exclusive period for filing a plan which could only be extended upon a showing that “the need for an increase is caused by circumstances for which the debtor should not be held accountable”. Further, all plans had to be filed within 180 days after the petition.
- The principal advantage to being a small business debtor under the 1994 amendments was the ability to seek “conditional approval” of a disclosure statement which would allow the debtor to solicit acceptances of the plan and then combine the final hearing on the disclosure statement with the hearing on confirmation of the plan. This reduced delay and costs for those debtors who did elect to be small business debtors under the 1994 amendments.

Very few debtors elected to be treated as small business debtors under the 1994 amendments because the costs saved by eliminating a separate hearing on the disclosure statement were too small to offset the burden of a 100 day exclusivity period and a 180 day deadline for filing all plans.

Bankruptcy Review Commission

In addition to creating the small business debtor election, the 1994 Bankruptcy Code amendments provided for the creation of a National Bankruptcy Review Commission. The Commission was charged with the responsibility of studying the nation’s bankruptcy laws and making recommendations for reform.

After two years of public meetings and hearings, the Commission submitted a formal report in October, 1997 which made many recommendations concerning bankruptcy law reform and specifically included about ten recommendations concerning reorganizations for small businesses.

The Commission report was in many respects strongly critical of Chapter 11 and its application in small business cases. The Commission report found that:

- Only a small fraction of Chapter 11 cases filed nationwide end with confirmation of a Chapter 11 plan of reorganization.

- The vast majority of cases are dismissed or converted.
- As few as 5% of Chapter 11 debtors confirm and then perform their plans and survive as operating entities.
- The Bankruptcy Code itself does not discourage those debtors that lack genuine prospects for reorganization from filing Chapter 11.
- Even moribund businesses generally have little to lose by filing for relief under Chapter 11.
- By filing under Chapter 11, debtors get the immediate benefit of the automatic stay and retain control of their business without any requirement of paying creditors or promptly filing a plan.
- Chapter 11 thus lures many small business debtors who have no realistic hope of confirming a plan.
- Too much time passes before those Chapter 11 cases which do not have viable businesses are either dismissed or converted.

The consequences of these findings, according to the Commission report, are as follows:

- Operating losses and professional fees erode the value of assets that could be used to pay creditors.
- Creditors lose the time value of money.
- The delay and costs in these cases undermine the legitimacy of Chapter 11 and its use by viable businesses.

The Commission report made a number of very specific recommendations.

- All of the recommendations of the Commission can be traced to one of two objectives:
 - Reduce costs and delays in those cases that actually do have a reorganization potential.
 - Take quicker action to remove from Chapter 11 those cases that do not have a realistic reorganization potential.
 - Not all of the Commission's recommendations made their way into BAPCPA.

- Since there is so little formal legislative history for BAPCPA, the Commission report is a valuable source of information regarding the purpose and proper interpretation of the small business provisions that did make their way into the 2005 amendments.

OBJECTIVES OF THE BAPCPA SMALL BUSINESS PROVISIONS

Keep in mind the twin goals articulated by the Bankruptcy Commission in analyzing provisions that address small business debtors and small business cases,

- Reduce costs and delay in those cases that have realistic reorganization potential.
- Have the courts bring Chapter 11 cases that do not have a realistic reorganization potential to an earlier end.

These two objectives underlie each of the new provisions. Some of provisions are designed to make reorganization more flexible and more expeditious for Chapter 11 debtors with genuine reorganization potential, while other new provisions are designed to increase oversight of the debtor and weed out those cases that should not be in Chapter 11.

SECTION BY SECTION ANALYSIS

There are seven separate sections of the Bankruptcy Reform Act and one provision in Title 28 of the United States Code that specifically address small business debtors and small business cases in Chapter 11. In addition, two bankruptcy rules that have been amended to address small business debtors in small business cases and at least a few other rules reference them as well.

Here are the specific sections of the Bankruptcy Code addressing small business debtors and small business cases.

- Who is a small business debtor and what is a small business case? § 101(51C) and 101(51D)
 - § 101(51C) defines a “small business case” as a case filed under Chapter 11 in which the debtor is a “small business debtor”.
 - § 101(51D) defines a “small business debtor” as a person engaged in commercial or business activity *having aggregate, non contingent liquidated secured and unsecured debt as of the petition date in an amount not more than \$2,000,000*

(emphasis added). Unlike prior law, this status is not optional. The statute creates a two part bright line test. The debtor is a small business debtor if:

- (i) the debtor is involved in a commercial or business activity (excluding the business of owning or operating real estate); and,
- (ii) the debtor is under the statutory limit of \$2,000,000 in aggregated, noncontingent, liquidated, secured and unsecured debt.

- The \$2,000,000 debt limit is:
 - exclusive of debts owed to affiliates or insiders;
 - subject to adjustment every three years under Bankruptcy Code § 104; and
 - is less than that recommended by the Commission report
 - The \$2,000,000 debt limit will sweep in a substantial majority of Chapter 11 cases according to a number of empirically based estimates.
- Is there any way to avoid being treated as a “small business debtor” if the debtor meets the statutory criteria?

- Not generally, but BAPCPA does provide one exception: if a creditors committee has been appointed by the U.S. Trustee, then the debtor will not be a small business debtor and the case will not be a small business case unless the Court “has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor.” 105(51D)

This exception reflects the statutory goal of increasing oversight over small business debtors. If there is a active committee, the law presumes less need for oversight and less need for the additional reporting requirements the statute imposes on a small business case.

- It seems unlikely that anyone contemplated that a case could start out as a small business case, cease to be one if a committee is appointed, then become one again if the Court determines that the committee is not active or representative enough, but it appears to be possible.
- Aside from changing deadlines for exclusivity and for filing a plan (which time period will control?), it’s uncertain what impact changing status could have. Would a small business case removed from the definition by the existence of a creditor’s committee, which becomes a small business case on a determination that the committee was not sufficiently active have to file retroactive reports for the period before it became a small business case complying with 11 U.S.C. § 308?

Who makes the small business debtor designation? *Rule 1020*

- The designation of small business debtor and small business case is made by the Debtor. In a voluntary case, Interim Bankruptcy Rule 1020(a) (entitled “small business debtor designation”) requires that the debtor state in its petition whether it is a “small business debtor.” In an involuntary case, the debtor has 15 days after the order for relief to file a statement of its status as a small business debtor. The “small business debtor” status is governed by the debtor’s statement, unless the Court orders that the debtor’s designation is incorrect.
- Bankruptcy Rule 1020(b) permits the U.S. Trustee or any party in interest to file an objection to the debtor’s self-designation as a small business debtor. The objection must be filed within 30 days after the first meeting of creditors or 30 days after any amendment to the statement, whichever is later.
- Given the short time frame for small business cases and the heightened reporting requirements for small business debtors, it seems more likely that there might be an objection filed by the U.S. Trustee or a party in interest if the debtor indicates that it is not a small business debtor.

Duties of the small business debtor under BAPCPA. *§1116*

- New Code Section 1116 imposes duties on a small business debtor beyond not required of other Chapter 11 debtors, beginning with the filing of the petition.
 - Under § 1116(1), the debtor must attach to its petition (or in an involuntary case, file within seven days after the date of the order for relief) either (a) its most recent balance sheet, statement of operations, cash flow statement and federal income tax return or (b) a statement made under oath that such documents have not been prepared and that such tax return has not been filed.
 - Under § 1116(2), the small business debtor “through its senior management” must attend meetings scheduled by the Court or the U.S. Trustee, including initial debtor interviews, scheduling conferences and 341 meetings, unless the Court after notice and hearing waives such requirements “upon a finding of extraordinary and compelling circumstances”.

Although the standard is set high for excusing these requirements, as a practical matter, the specific duties imposed by § 1116(2) (in contrast to the new filing requirements under § 1116(1)), will not significantly expand the burdens on small business debtors in districts where most of the required actions are already taking place as a matter of U.S. Trustee requirements. In the Eastern District of Michigan, for example, under pre-BAPCPA law, the U.S. Trustee conducted an initial debtor in possession meeting for the purposes of discussing the U.S.

Trustee's operating instructions in Chapter 11 and every judge conducts some form of initial Chapter 11 conference at which someone from the debtor's senior management is required to attend. While § 1116(2) makes these duties and obligations mandatory for small business debtors, it may not, as a practical matter, work a substantial change in current practice.

- § 1116(3) reiterates the small business debtor's obligation to timely file its schedules and statement of financial affairs and limits any extension of the time to file its schedules and statement of financial affairs to 30 days "absent extraordinary and compelling circumstances".
 - This requirement does impose an additional real world burden upon small business debtors, who are often thin on management resources and accurate financial information.
- § 1116(4) requires a small business debtor to file all post petition financial and other reports required by Federal Rules of Bankruptcy Procedure or by Local Rules of District Court, redundant because it simply requires the small business debtor to comply with other provisions of Federal Bankruptcy Rules and Local District Court Rules.
- § 1116(5) requires the small business debtor to maintain "insurance customary and appropriate to the industry". This has generally been a requirement imposed by the U.S. Trustee's operating instructions for all Chapter 11 debtors, but the statute makes it an explicit requirement only for small business debtors.
- § 1116(6) imposes a specific duty to file timely all tax returns "and other required government filings". The statute provides no guidance as to what may constitute an "other required government filing".
- § 1116(7) requires the small business debtor to permit the U.S. Trustee to have access to the debtor's business premises, books and records at reasonable times upon reasonable notice.
- Some of the requirements of § 1116 are duplicative of other requirements typically imposed on Chapter 11 debtors by local rule, but BAPCPA makes them explicit for small business debtors only. It remains to be seen whether litigation will ensue over issues such as what is "insurance customary and appropriate to the industry" and what an "other required government filing" is. It seems paradoxical that § 1116 imposes more stringent burdens on the debtors with the least resources.

Additional Reporting Requirements in Small Business Cases. §308(b)

- As if the initial reporting requirements under § 1116 weren't enough for small business debtors, a new § 308 was created entitled "Debtor reporting requirements" [sic]. The title

is a little misleading. This section does not apply to all debtors - the operative language of this section is all contained in § 308(b) and pertains only to small business debtors.

- §308(b) requires small business debtors to file periodic financial and other reports that contain information regarding (1) the debtor's profitability, (2) projections of the debtor's cash receipts and disbursements "over a reasonable period" (an undefined term), (3) comparison of actual receipts and disbursements with projections and (4) statements of compliance with all other reporting requirements under Federal Bankruptcy Rules, timely filing of tax returns and "other required government filings," timely payment of taxes and other administrative expenses when due. If the debtor reports under this sub-section that it is not in compliance with all of these requirements, it must explain its failures and describe how, when and at what cost the debtor expects to remedy them.
- § 308 is a list of additional reporting obligations for small business debtors only. Practitioners need to be aware of the ongoing reporting requirements under § 308, as well as additional initial reporting required under § 1116.
- In an effort to standardize reporting and simplify it for small business debtors, official forms will be adopted for the required reports under § 308. Section 308 *will not be effective until 60 days after rules have been prescribed to establish these official forms.*
- Is there hidden value to the small business debtor in the new reporting requirements? They may help instill some discipline in those small businesses where financial records are in disarray and management has failed to comparing projections/pricing with actual operating statements.

Does BAPCPA provide any additional flexibility for small business debtors? § 1125(f)

- § 1125(f) may be the only provision that specifically confers a benefit upon a small business debtor.
- § 1125(f) permits the Court to do one of three things for small business debtors.
 - Under § 1125(f) (1) the Court may determine that the plan itself contains enough information so that a disclosure statement is not necessary at all.
 - Under § 1125(f) (2) the Court may approve a disclosure statement submitted on a standard form which is expected to be created and ultimately approved by the judicial conference under 28 USC § 2075.
 - Under § 1125(f)(3), even if the disclosure statement is not on the standard form, the Court may conditionally approve it so as to permit the debtor to combine a final hearing on the disclosure statement with confirmation of the plan itself. This provision reflects what a number of districts (including the Eastern District of

Michigan) have allowed by local rule in cases where debtors have elected “fast track” treatment in their Chapter 11 cases.

Plan and Disclosure Statement Filing Deadlines for the small business debtor. § 1121(e)

- Section 1121(e) provides that a small business debtor has 180 days of exclusivity. That is 60 days longer than for other Chapter 11 debtors (exclusivity may be extended, but not shortened - see discussion below).
- The deadline for filing the plan and any disclosure statement in a small business case is 300 days after the petition. This is longer than under the 1994 amendments, which permitted only 160 days for plans to be filed by small business debtors.
- Congress has made it more difficult for small business debtors to obtain an extension of the exclusivity period. Under § 1121(e)(3)(A), neither the 180 day exclusivity period nor the 300 day plan filing deadline in a small business case can be extended unless after notice and hearing the debtor “*demonstrates by a preponderance of the evidence that it is more likely than not that the Court will confirm a plan within a reasonable period of time*” (emphasis added); AND
 - The Court may only grant an extension for a small business debtor if a new deadline is then imposed and the order extending time is signed before the existing deadline has expired. §1121(e) (3) (B) and (C).
 - In contrast, the 120 day exclusive period for other Chapter 11 debtors can be extended for “cause”.
 - There is no provision to shorten the exclusivity period for small business debtors.

Plan Confirmation. § 1129(e)

- Section 1129(e) poses yet another deadline but this deadline applies both to the small business debtor and the Court. Under § 1129(e) the Court must confirm a plan in a small business case filed within the deadline set under § 1121(e) and in compliance with the provisions of Chapter 11 “not later than 45 days after the plan is filed, unless the time for confirmation is extended in accordance with § 1121(e) (3)”.
- This 45 day deadline under § 1129(e) may only be extended by the Court if the debtor can meet the “preponderance of the evidence” standard set forth in § 1121(e)(3)(A), along with the additional requirements of §§ 1121(e)(3)(B) and (C).
- 1129(e) strips the court of much discretion, and has the potential to create havoc with the Court’s docket. The 45 day confirmation period cannot be extended without a “mini-trial” to establish by a preponderance of the evidence the likelihood of a plan being

confirmed under § 1121(e)(3). Many confirmation hearings are contested, requiring the attendance of witnesses who may not be available within the 45 day period. The court may not have sufficient time open in its calendar to complete a lengthy hearing within the 45 day period.

Serial filings by small business debtors. §362(n)

- § 362(n) of the Bankruptcy Code addresses serial filings by small business debtors.
- Section 362(n) provides that the automatic stay does not apply in a case in which the debtor:
 - is a debtor in a small business case pending at the time the petition is filed; [and]
 - was a debtor in a small business case that was dismissed within two years before the date of the order for relief in the present case; [or]
 - was a debtor in a previous small business case where a plan was confirmed within two years before the order for relief in the present case; [or]
 - is an entity that acquired substantially all of the assets or business of an entity that is a small business debtor in a current case or was a small business debtor within two years before the present case unless the new entity establishes by a “preponderance of the evidence” that it “acquired substantially all of the assets or business of such small business debtor in good faith and not for the purpose of evading this paragraph”.
- The provisions of § 362(n) (1) (D), treat the *purchaser* of assets or business from a small business debtor as a serial filer if the *seller* from which the business was purchased had availed itself of bankruptcy relief at any time in the prior two years. Only if the purchaser can prove by a “preponderance of the evidence” that it acquired the assets or business of its predecessor “in good faith” and not for purposes of evading the serial filer rules can it hope to obtain the benefit of the automatic stay. The statute essentially presumes bad faith and puts the burden upon the “new” debtor, which has never previously filed, to rebut the presumption. The procedural vehicle to make this showing is not specifically addressed by § 362(n).
- Also, because of § 362(n), a small business debtor which has confirmed a Chapter 11 plan a plan but subsequently experiences financial difficulties and wishes to liquidate will likely not be able to do so in Chapter 7, unless friendly creditors will assist by filing an involuntary petition or the court agrees to reopen the prior Chapter 11 case. § 362(n) (2) (A) exempts involuntary cases from the provisions of § 362(n) (1).
- Section 362(n)(2) also exempts a debtor from the serial filer provisions of § 362(n)(1)if the debtor can prove “by a preponderance of the evidence that the filing of the petition resulted from circumstances beyond the control of the debtor not foreseeable at the time

the case then pending was filed” and that it is “more likely than not that the Court will confirm a feasible plan, but not a liquidating plan, within a reasonable period of time” in the second case.

- The plain language of the statute virtually bars a subsequent Chapter 7. There is no set of circumstances where a Chapter 7 debtor can propose a confirmable, feasible plan, and Chapter 7 cannot work without the automatic stay. The only options for a bankruptcy supervised liquidation would be asking creditors to file an involuntary case, or attempting to reopen the original Chapter 11 case for the purpose of liquidating, rather than filing a new case.

Who enforces the heightened oversight in small business Chapter 11’s. § 586

- The U.S. Trustee has heightened responsibilities under 28 U.S.C. § 586.
- 28 U.S.C. § 586(7) specifically imposes upon the U.S. Trustee various duties including conducting interviews investigating the debtor’s viability, inquiring about the debtor’s business plan, and in cases where it is appropriate, visiting the debtor’s business premises.
- In the Eastern District of Michigan, the U.S. Trustee has Chapter 11 operating instructions which address certain of these oversight functions and performs some of them already. However, this statute explicitly imposes these duties upon the U.S. Trustee in any small business cases under the Reform Act.

OTHER ISSUES TO BE AWARE OF FOR SMALL BUSINESS DEBTORS UNDER BAPCPA

- Utility provisions: The changes in § 366(d)(2) that enhance the rights of a utility applied to all Chapter 11 cases, including small business cases.
- Reclamation remedies under § 546(c) and the elevation of certain vendor claims to administrative expense priority under § 503(b)(9) have equal application in small business Chapter 11 cases and can result in increased administrative expenses that you need to be aware of if you are filing small business cases.
- BAPCPA also provides for a study of the operation of Chapter 11 by the administrator of the Small Business Administration. The study is to address the internal and external factors that cause small businesses to become debtors and that cause some small businesses to successfully complete cases while others do not. This report is expected to take two years to complete and will also address what other changes can be made to make small business Chapter 11’s more viable and more efficient.

CONCLUSION

As you can see, there are significant specific provisions addressing small business cases under the new law. These provisions are a clear message to the court and debtors in these cases to move them along with greater speed, bringing cases with little chance of success to a quick end.