

Small Business Bankruptcy Reform:
Codifying Best Practices

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Not to be overlooked in the avalanche of criticism following the June 10, 1998, passage of H.R.3150 are the provisions for small business bankruptcy reform. A companion bill in the Senate, S.1914, contains similar provisions. Unlike the legislative proposals addressing consumer bankruptcy, the small business provisions for Chapter 11 cases in H.R.3150 and S.1914 emerged from the National Bankruptcy Review Commission with near consensus. The provisions reform, but do not radically change, the fundamental processes of Chapter 11.

Some commentators inaccurately criticize the small business provisions as "untested."¹ Others, unaware that United States Trustees currently perform many duties set forth in the legislation, substantially overstate the provisions' effect on United States Trustee offices.² Still others overlook the valuable tools in the bills for debtors, not just third parties, to evaluate their businesses.³

In reality, the provisions in H.R.3150 and S.1914 for

¹ Letter to Rep. Jerrold Nadler from Jere W. Glover, Office of the Chief Counsel for Advocacy, Small Business Administration, dated April 22, 1998.

² On June 16, 1998, ABI posted on its website "An Analysis of S.1914, Business Reorganizations Provisions" by Christian Onsager. On July 6, 1998, ABI posted a reply from Joseph Guzinski, Assistant Director for Research and Planning at the Executive Office for United States Trustees, explaining that Onsager overestimated the number of additional United States Trustee Program employees necessary to implement the legislation.

³ See "Bankruptcy Changes Could Harm Instead of Help," Los Angeles Times, 5/27/98, page D5; "Chapter 7 Changes Eclipse Small Business Provisions," National Law Journal, Vol. 20, No. 43, June 22, 1998, page B4.

business bankruptcy reform codify the current best practices of United States Trustees. The proposed small business provisions will place into law a system that United States Trustees already use in many parts of the country to help the debtor assess its prospects for success early in the case and understand Chapter 11. In my opinion, based on 16 years of practice representing debtors, creditors, and creditors' committees in Chapter 11 cases and four years as a United States Trustee, the small business provisions will result in quicker business reorganizations, help the courts and the United States Trustees weed out businesses that have no hope of succeeding, and shift the focus of Chapter 11 from costly and slow litigation to the debtor's business, where it belongs.

The Need for Chapter 11 Reform

Chapter 11 is a valuable tool. It gives small and large businesses alike a breathing space from their creditors, a chance to reorganize, a "fresh start." It provides a unique opportunity to restructure the results of past mistakes for future success. But Chapter 11 is not a miracle or a panacea. To succeed in Chapter 11, current management must quickly put an end to business as usual.

Since June 1994, I have served as United States Trustee in Region 17, which covers the federal judicial districts of Northern and Eastern California and of Nevada. I am responsible for supervising the administration of the bankruptcy cases filed in the region--85,000 cases filed over the last 12 months--including 700 pending Chapter 11 cases.

Since my appointment as United States Trustee, I have established a few "non-lawyer" facts about Chapter 11.

First, many Chapter 11 cases are really about people. Too often, the debtor's principals are stressed-out disorganized entrepreneurs accustomed to operating in an unstructured environment. Chapter 11 is like a bucket of cold water.

Second, cases are frequently the direct result of disorganization and failed management. Failure to cover payroll taxes, answer a lawsuit, or resolve cash flow problems precipitates the Chapter 11 filing.

Third, the debtor almost always lacks a meaningful management information system. Rare indeed is the debtor who can produce an accurate profit-and-loss statement or who knows

the profit margins on particular lines of products. In the course of trying to define "small business," the Small Business Working Group of the National Bankruptcy Review Commission asked me to research the income levels of Chapter 11 debtors.⁴ I found that almost 50 percent of Chapter 11 debtors in San Francisco could not state their gross income from the year prior to the filing; they simply left blank the space for income on the Statement of Financial Affairs. United States Trustees in other regions report the same practice.

Finally, debtors rarely have an exit strategy for Chapter 11. The Chapter 11 filing alone is the solution to their problems.

H.R.3150 and S.1914 acknowledge these problems and call for several changes: (1) early evaluation of the case's financial viability by the United States Trustee; (2) prompt plan filing and plan confirmation deadlines; (3) under certain circumstances, a debtor's showing of ability to reorganize; and (4) uniform financial reporting.

United States Trustee's Early Intervention

The small business provisions in H.R.3150 and S.1914 will improve the administration of Chapter 11 cases because they codify the best practices of United States Trustees, the administrators of the Bankruptcy Code. In large cases, creditors' committees keep the debtor moving, but creditors' committees are either non-existent or inactive in small cases. Only five Chapter 11 cases filed last year in San Francisco had active creditors' committees represented by counsel. It is the United States Trustee who is left to move the cases along and make the debtors accountable.

The legislation calls for quicker resolution of Chapter 11 cases by focusing, in the initial stages of the case, on the debtor's ability to reorganize. H.R.3150 and S.1914 require the debtor to file its latest balance sheet and tax

⁴ The National Bankruptcy Review Commission considered but rejected an income definition and adopted a debt definition. Following the Commission recommendation, H.R.3150 and S.1914 both use debt levels to define "small business." Non-contingent liabilities of \$5 million or less place a Chapter 11 debtor into the small business category. Our research shows that between 85 percent and 90 percent of Chapter 11 cases will fall into the category.

return with the petition or explain why they are not available. Both bills require that, after filing, the debtor attend an interview with the United States Trustee, file periodic financial reports projecting cash receipts and disbursements, file timely tax returns, pay post-petition taxes, and file timely a plan and disclosure statement. These requirements may be new to the Bankruptcy Code, but they are not new to the practice of United States Trustees in many regions.

United States Trustees have long endorsed early evaluation of the viability of Chapter 11 cases. It has been the practice of many United States Trustees to conduct an initial debtor interview ("IDI") with the debtor's principal and often its financial officer shortly after the case is filed and prior to the §341(a) meeting. On January 1, 1995, six months after I became United States Trustee, Region 17 started conducting IDIs. Since then, the San Francisco office alone has conducted 330 IDIs in cases large and small. Debtors' attorneys praise the IDI, stating that it reinforces the advice they give their clients and impresses upon the debtors the need to focus on successfully exiting Chapter 11.

Here is how the IDI works. After a Chapter 11 case is filed, a United States Trustee Program bankruptcy analyst--often a certified public accountant--reviews the debtor's schedules and statements and asks the debtor to provide specific materials such as profit-and-loss statements, balance sheets, tax returns, and bank statements. The analyst examines the debtor's record of profitability, assets, expenditures, and financial trends.

The analyst then meets with the debtor and debtor's counsel to discuss the reasons for the filing, debtor's management procedures, and the likely path toward successful reorganization. This process has two goals. First, the IDI provides the opportunity to discuss what the debtor will be required to do in Chapter 11 and how it is going to get out of Chapter 11. Second, the IDI allows the United States Trustee to assess the debtor's financial viability.

In addition to specific questions about the financial records, what does the United States Trustee analyst ask the debtor? The analyst asks questions like: Why did you have to file a Chapter 11 case? What are your business plans? Where are your books and records? Are your tax payments current? Are your assets insured? Most important, what steps will you take to turn around your business?

What kind of answers does the bankruptcy analyst receive? Not surprisingly, the books and records of many Chapter 11 debtors are often in such poor condition that the debtor cannot answer the questions, let alone manage the business.

Early intervention in Chapter 11 cases has proven very successful. In San Francisco, only 17 percent of Chapter 11 cases filed in 1992 resulted in confirmed plans of reorganization. Since the San Francisco office started conducting IDIs and became more active in filing motions to dismiss or convert based on our increased knowledge of the debtors' core businesses, the confirmation rate in San Francisco has increased to 33 percent for cases filed in 1996. Additionally, the time for resolution--either by confirmation, dismissal, or conversion--of Chapter 11 cases filed in 1996 decreased by five months. About 65 percent of Chapter 11 cases filed in Region 17 are now resolved within a year--an increase of more than 20 percent from 1994 when I was appointed.

My experience with these practices mirrors that of United States Trustees throughout the country. Recent data confirm that Chapter 11 cases of all types are moving through the system more quickly and that a substantial percentage are being confirmed.⁵ Chapter 11 cases are not languishing as they used to, and United States Trustees have been essential in moving these cases along.

Requirement of Timely Reorganization

A second change proposed by the small business provisions is to limit the period the debtor may stay in Chapter 11 without demonstrating the ability to reorganize. Both H.R.3150 and S.1914 allow 90 days to file a plan and 150 days to confirm it.

The concept of deadlines for filing and confirming a plan is controversial but not new. Under the seldom-used small business election provisions added by Congress in the Bankruptcy Reform Act of 1994, debtors must file a plan within 160 days. The Bankruptcy Code permits the court to shorten the period, but does not allow the electing small business to extend it.

⁵ "Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions," Gordon Bermant and Ed Flynn, ABI Journal, Vol. XVII, No. 1, February 1998, page 8.

The deadlines for filing and confirming a plan in H.R.3150 and S.1914 are not absolute. Unlike the deadlines imposed by the 1994 Reform Act, both can be extended by the debtor. The extension comes at a price consistent with the goals of early case disposition and debtor responsibility. To obtain the extension, the debtor has the burden of showing a reorganization is likely.

S.1914 requires the debtor to make this showing by clear and convincing evidence. The United States Trustee Program suggests changing the standard to a "preponderance of the evidence"--that it is more likely than not the debtor can confirm a plan--consistent with the other provisions in S.1914 that place a burden upon the debtor and consistent with H.R.3150.

To simplify the process of filing a plan for small businesses, both H.R.3150 and S.1914 permit the small business debtor to use standard form disclosure statements and plans and, where appropriate, eliminate the disclosure statement altogether.

Debtor's Burden of Proof

In its report, the National Bankruptcy Review Commission noted that "perhaps the most difficult problem in reforming Chapter 11 for small business cases is to find a way to identify promptly and reliably those cases that have no genuine prospects for reorganization." The hallmark of these cases is that once the petition and schedules are filed, the debtor fades from view.

H.R.3150 and S.1914 deal with this problem by amending §1112(b) to add explicit benchmarks for the debtor's performance. The statutory change applies to all Chapter 11 cases, both large and small. Along with the traditional grounds for converting or dismissing a case such as continuing losses or failure to confirm a plan, the legislation compels the debtor to keep current on administrative taxes, file timely schedules and statements, and provide documents and attend meetings requested by the United States Trustee.

The amendment includes a subtle but important change intended to expedite the process of disposing of the large number of Chapter 11 cases unlikely to reorganize. Under current law, if the debtor delays or fails to progress in the Chapter 11 case, the United States Trustee and other parties

in interest must file motions under §1112(b) to advance the case. As movants, these parties bear the burden of proving the company cannot reorganize.

H.R.3150 and S.1914 alter the burden. If a party in interest establishes "cause" to convert a case, such as the failure to file schedules or to meet with the United States Trustee, the burden of proof shifts to the debtor. This shift will change the culture in Chapter 11.⁶ To remain in Chapter 11 and retain the benefits of the automatic stay, the debtor will have to justify the omission and prove the likelihood of confirming a plan within the established time frame. The focus is on the debtor and its ability to reorganize, just as it ought to be.

Periodic Financial Reports

Another important tool for the small business debtor in H.R.3150 and S.1914 is the creation of uniform periodic financial reporting to show the debtor's profitability, cash receipts and disbursements, and the timeliness of tax returns and payments of administrative claims. United States Trustees across the country have long used monthly operating reports to help the debtor assess and monitor its financial condition. United States Trustees have found that debtors who regularly file these reports are better able to cope with Chapter 11 and to reorganize their businesses. Conversely, debtors who do not file monthly operating reports or file inaccurate or incomplete reports are likely not to reorganize.

On January 1, 1995, the United States Bankruptcy Court for the Northern District of California adopted new monthly operating report forms. The forms resulted from the joint efforts of the courts, the United States Trustee, insolvency accountants, and attorneys. They are based on accrual accounting and tailored for three broad categories of cases-- real estate, individual, and general business. Shortly after the forms were adopted, the United States Trustee's offices in San Francisco, Oakland, and San Jose began offering classes on how to complete and analyze the monthly operating reports. At

⁶ One commentator points out that the burden shift will bring the imposition of the automatic stay in line with the treatment of other injunctions in American jurisprudence. See "The Commission's Small business Proposal: Up or Out," Hon. Thomas E. Carlson, Northern District of California, ABI Journal, Vol. XVI, No. 10, December/January 1998, page 30.

the IDI, the bankruptcy analyst now gives the debtor an interactive computer disk to guide the debtor through the process of completing the operating report. The debtor is encouraged to call the analyst throughout the case and especially during the preparation of the first monthly operating report.

Reforms for a "Fresh Start"

To get on the right track--to make Chapter 11 work--a small business debtor must put its books and records in order, provide periodic financial reports on business operations, keep current on obligations incurred post-petition, and determine what revenue its core business is generating. In short, the small business debtor has to know whether its business can be reorganized.

United States Trustees support the reforms in S.1914 and H.R.3150 for Chapter 11 business debtors. No debtor will be able to sit idle. The expanded grounds for conversion and dismissal and the shifting of the burden to the debtor to justify retaining control of the business will help all parties in interest. The small business provisions codify the best practices developed by United States Trustees to move cases along. They streamline the Chapter 11 process and place the emphasis where it belongs--on the debtor--if a business is to emerge successfully from Chapter 11.

In short, the provisions strengthen the integrity of the Chapter 11 process so that Chapter 11 cases provide a genuine opportunity for a fresh start.