

NO EASY ANSWERS: SMALL BUSINESS BANKRUPTCIES AFTER BAPCPA

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Abstract: Among the changes the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 brings to the Bankruptcy Code are a host of new burdens on small business debtors attempting to reorganize under Chapter 11. This Article examines those provisions affecting small business debtors and outlines suggestions for navigating through the new requirements without jeopardizing a small business's chances for a successful and expeditious reorganization. In particular, this Article argues for the formation of active prepetition creditors' committees for those businesses that intend to seek Chapter 11 protection. Finally, this Article suggests that a potential solution to the problems faced by small business lies in expanding Chapter 12 to permit non-agricultural small businesses to fall within its protection.

INTRODUCTION

With the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"),¹ the future looks more troubled than ever for the small business in financial distress. Although BAPCPA was trumpeted on its way to passage as a legislative solution to perceived widespread abuse in the consumer bankruptcy

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¹ Pub. L. No. 109-8, 119 Stat. 23 [hereinafter BAPCPA] (to be codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.) (enacted Apr. 20, 2005). BAPCPA became generally effective on October 17, 2005, although selected provisions, not pertinent to this discussion unless specifically so stated, became effective upon enactment.

arena, the legislation also heavily affects business reorganizations, particularly small business reorganizations.²

Although the historical concerns underlying past initiatives to reform small business reorganizations³ have worth, and although some pre-BAPCPA initiatives reduced the time and expense of Chapter 11 practice, we believe that the value of BAPCPA's reforms is outweighed by the procedural burdens the statute imposes on small business debtors. The Chapter 11 process is now chock full of new postpetition documentation, reporting, and related requirements, while, at the same time, it invites early contests where the debtor will bear the burden of proving its reorganizational mettle. The result places potentially debilitating burdens on small business debtors that embark on statutory reorganization in financial *extremis*.

At the same time, BAPCPA fails to offer the one truly innovative reform that could streamline small business reorganizations: availability of a Chapter 12-type model for plan confirmation under the auspices of an independent, non-operating trustee, without the necessity of creditor solicitation and voting.

Part I of the Article summarizes the key recent changes to the Bankruptcy Code affecting the small business debtor and general BAPCPA provisions affecting such debtors.⁴ Part II then makes a series of practical suggestions for courts and lawyers regarding the treatment of small business debtors under the Bankruptcy Code.⁵

² See, e.g., *Bill's Fine Print Reveals Sneak Attack on Chapter 11 Practice*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Apr. 5, 2005, at 1.

³ We will discuss more precisely the contours of small business reorganizations below. For now, the reader should know that BAPCPA singles out debtors with less than \$2,000,000 aggregate, noncontingent, liquidated, secured, and unsecured debt (other than debt to affiliates and insiders) for potential special treatment as a small business. BAPCPA § 432, 119 Stat. at 110 (to be codified at, and amending, 11 U.S.C. § 101, adding § 101(51D)). We recognize, too, that many individual bankruptcies (generally characterized as "consumer" cases) are, in truth, the result of business failure. See Robert M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 CAL. L. REV. 743, 747 (2005). We will not attempt to treat the myriad issues unique to individual Chapter 11 cases.

⁴ See *infra* notes 6–83 and accompanying text.

⁵ See *infra* notes 84–123 and accompanying text.

I. PROBLEMS FOR THE SMALL BUSINESS DEBTOR UNDER THE BANKRUPTCY CODE

A. *Summary of Recent Concerns and Suggested Reforms Concerning Small Businesses in Chapter 11*⁶

The small business changes wrought by BAPCPA are a product of longstanding frustration with the suitability of the Bankruptcy Code's Chapter 11⁷ for small enterprises.⁸ In the years since the Bankruptcy Code's passage, a number of bankruptcy courts effected their own reforms, attempting to streamline reorganization for small businesses,⁹ and Congress in 1994 passed what proved to be an unsatisfactory attempt to tailor Chapter 11's processes to the needs of small business cases.¹⁰

Throughout the 1980s and 1990s, observers commented that the Bankruptcy Code's "one-size-fits-all" reorganization chapter, in which mom-and-pop stores followed the same reorganization steps as Fortune 500 conglomerates, saddled small businesses and closely held enterprises with a cumbersome, expensive, and slow-moving procedure.¹¹ The pre-BAPCPA reforms were aimed chiefly at reducing the time debtors spent in Chapter 11, by accelerating reorganization through a combination of early status conferences with the court, firm (and early) deadlines for filing a plan, quick disapproval—or conditional approval—of disclosure statements, plan solicitation using

⁶ For a pithy and insightful review of bankruptcy reorganization's evolution and its relation to contemporary circumstances, see Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004).

⁷ The current law of bankruptcy is found in Title 11 of the U.S. Code. See 11 U.S.C. §§ 101 *et seq.* (2000). Its foundation is the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (effective Oct. 1, 1979) (codified as amended at 11 U.S.C. 101 *et seq.* (2000)). References in this work to the "Bankruptcy Code" or "Code" are to Title 11 of the U.S. Code. References to "Chapter 11" are to 11 U.S.C. §§ 1101-1174 (2000). References to "Chapter 12" are to 11 U.S.C. §§ 1201-1231 (2000); references to "Chapter 13" are to 11 U.S.C. §§ 1301-1330 (2000).

⁸ See Hon. Leif M. Clark, *Chapter 11—Does One Size Fit All?*, 4 AM. BANKR. INST. L. REV. 167, 176-77 (1996).

⁹ See Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 751-52 (describing initiatives developed in the Eastern District of North Carolina); Hon. A. Thomas Small, *Paying the Piper: Rethinking Professional Compensation in Bankruptcy*, 1 AM. BANKR. INST. L. REV. 305, 315 (1993) (describing the adoption of North Carolina procedures in other districts).

¹⁰ Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 217, 108 Stat. 4106 (codified as amended at 11 U.S.C. §§ 101, 1102, 1112, 1121, 1125).

¹¹ See Clark, *supra* note 8, at 176-77; LoPucki, *supra* note 9, at 730-31, 744-45; Small, *supra* note 9, at 305-06.

a conditionally approved disclosure statement, and a combined hearing addressing both final approval of the disclosure statement and plan confirmation.¹² The 1994 amendments to the Bankruptcy Code provided clear statutory authority for such reforms, but left it to the debtor to elect small business, or "fast track," treatment.¹³ Experience proved that, although the fast-track treatment could be the best medicine to enhance a reorganizing debtor's prospects, it was not a medicine debtors were inclined to self-administer.¹⁴ The treatment required prescription. BAPCPA wrote the script, and more.¹⁵

A second objective of pre-BAPCPA reform efforts was to identify early, and weed out, cases for which there was no reasonable likelihood of reorganization.¹⁶ The reformers considered that a bankruptcy judge's disciplined use of status conferences early in a case, combined with procedural orders designed to expedite the case's travel to confirmation and more comprehensive post-filing financial reporting, would prevent these so-called "dead-on-arrival" debtors from languishing in Chapter 11 to no good end.¹⁷

The National Bankruptcy Review Commission ("NBRC") embraced many reform initiatives in its 1997 report. For what it considered to be the "relatively small proportion of cases in which the debtor has a reasonable likelihood of confirming a plan and succeeding as a

¹² See Small, *supra* note 9, at 307-11. Judge Small is credited with pioneering efforts to streamline Chapter 11 for small businesses in the Eastern District of North Carolina.

¹³ The 1994 amendments included a statutory definition of "small business" as operating companies with aggregate, noncontingent, liquidated, secured, and unsecured debts less than \$2,000,000. 11 U.S.C. § 101(51C) (2000), amended by BAPCPA, Pub. L. No. 109-8, § 432(a), 119 Stat. 23, 110. Qualifying debtors could elect small business treatment. 11 U.S.C. § 1121(e) (2000), amended by BAPCPA § 437, 119 Stat. at 113. The election reduced the exclusivity period for filing a plan (from 120 to 100 days) and for plan confirmation (from 180 to 160 days), *id.*, but authorized the debtor to obtain conditional approval of its disclosure statement, solicit plan acceptances with the conditionally approved statement, and proceed to a hearing at which final approval of the disclosure statement and confirmation would be considered together. 11 U.S.C. § 1125(f) (2000), amended by BAPCPA § 431, 119 Stat. at 113.

¹⁴ Most debtor's counsel preferred not to elect mandatory shortened deadlines for plan filing and confirmation. They understood, also, that an involved judge could impose early deadlines, but they expected that to happen only after a status conference and a case-specific determination. Of course in those jurisdictions adopting Judge Small's procedures, small business debtors were automatically fast tracked when their size put them within the small business category.

¹⁵ See *infra* notes 23-58 and accompanying text.

¹⁶ See NAT'L BANKR. REVIEW COMM'N, *BANKRUPTCY: THE NEXT TWENTY YEARS* at 610 (1997); Donald R. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, 23 CAP. U. L. REV. 413, 428-34 (1994).

¹⁷ See LoPucki, *supra* note 9, at 749-52.

going business," it recommended simplifying disclosure and plan confirmation; mandating prompt plan filing and confirmation; and requiring additional, regular reports of operations, with increased oversight from the Office of the U.S. Trustee.¹⁸ As for the balance of Chapter 11 cases (the dead-on-arrival cases), the Commission recommended other reforms with the objective of ousting them from Chapter 11, by conversion or dismissal, as early in the case as possible.¹⁹

The essential conclusion of the Commission's recommendations,²⁰ many of which later were incorporated in BAPCPA, was that "the appropriate use of Chapter 11 is one in which the debtor confirms and materially performs a plan of reorganization."²¹ The Commission did not decide that Chapter 11 was any better suited for "orderly liquidations" than Chapter 7, and stated that "[a] case which is converted . . . after a lengthy, inconclusive protection of the debtor in possession . . . should not be considered a success."²²

Of course, there is quite a gap between a confirmed, consummated plan and dismissal or conversion after lengthy, inconclusive delay. Success comes in many forms. To say that confirmation and consummation is *the* appropriate use of Chapter 11 ignores, among other things, that the essential purpose of the process is to rehabilitate the debtor while treating creditors fairly. If that can be accomplished with the aid of Chapter 11, but without consummating a plan, is it appropriate to condemn the result?

¹⁸ NAT'L BANKR. REVIEW COMM'N, *supra* note 16, at 609-10.

¹⁹ *See id.* at 610-13.

²⁰ *See id.* at 609-705.

²¹ *Id.* at 611.

²² *See id.* The Commission did acknowledge that different measures of success are possible:

Reasonable people differ about how to define 'success' in Chapter 11 cases. Some argue that a Chapter 11 case in which no plan is confirmed should be considered successful where the case produces an orderly sale of assets or a negotiated solution without a formal plan. Creditors may define success in terms of distribution amounts or in terms of preserving future dealings with the debtor. The debtor, on the other hand, may define success in terms of job preservation, enhancement of going-concern value, or future returns to equity. The public may define success in terms of overall fairness.

Id. (footnotes omitted). *See generally* Hon. Leif M. Clark et al., *What Constitutes Success in Chapter 11? A Roundtable Discussion*, 2 AM. BANKR. INST. L. REV. 229 (1994) (exploring the various measures of success for different Chapter 11 constituencies).

B. BAPCPA and Small Business Debtors

1. The Statutory Small Business Debtor

BAPCPA reflects a legislative determination that dictating *how*—and *when*—things get done in a Chapter 11 case will dictate *what* gets done. This proposition has application generally for reorganizing debtors, but it is particularly true for those falling within the new definition of “small business debtor” set forth by BAPCPA in amended Code § 101(51D). BAPCPA adds the following definition of the statutory small business debtor²³ to the Bankruptcy Code:

“small business debtor”—

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than \$2,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor, and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,000,000 (excluding debt owed to 1 or more affiliates or insiders).²⁴

For our purposes, we can treat this definition as establishing that businesses with less than \$2,000,000 in non-insider, non-affiliate debt are statutory small business debtors unless a creditors' committee has been appointed.²⁵

²³ We use the term “statutory small business debtor” to refer specifically to those entities that fit the new § 101(51D) definition. As discussed below, there are a great many small businesses that fall outside the definition.

²⁴ BAPCPA § 432(a), 119 Stat. 23, 110 (to be codified at 11 U.S.C. § 101(51D)).

²⁵ One could conclude that businesses within the small business debt limit, and for which a committee is appointed, float in definitional limbo, depending on whether its

a. *Expanded Duties of the Small Business Debtor*

BAPCPA assigns the statutory small business debtor expanded duties.²⁶ It must append to its petition, or in an involuntary case file within seven days of the order for relief, "its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return" or file a verified statement that no such documents have been prepared, or that the tax return has not been filed.²⁷ It must "attend, through its senior management" and counsel, "meetings" scheduled by the court or the U.S. trustee, "including initial debtor interviews, scheduling conferences, and meetings of creditors" unless the court, after notice and hearing, waives the requirement "upon a finding of extraordinary and compelling circumstances."²⁸ The small business debtor must also timely pay all postpetition taxes, file all tax returns and other "required government filings," maintain insurance "appropriate to the industry," and file all "postpetition financial and other reports" required by the Federal Rules of Bankruptcy Procedure or local rule.²⁹

committee remains "sufficiently active and representative." See INTERIM BANKR. R. 1020 (adopted Aug. 22, 2005), available at http://www.uscourts.gov/rules/BK_Interim_Rules_Clean.pdf (establishing processes for determining statutory small business debtor status). First, a Chapter 11 debtor is required to state in its petition whether or not it is a small business debtor. INTERIM BANKR. R. 1020(a). In involuntary cases, they must so state within three days of the order for relief. *Id.* The case will proceed in accordance with the designation "unless and until the court enters an order finding that the debtor's statement is incorrect." *Id.* The U.S. trustee and parties in interest may object to the debtor's designation, but must do so within thirty days after the meeting of creditors concludes, or within thirty days of any amendment to the designation. INTERIM BANKR. R. 1020(b). If a creditors' committee is appointed, the case will not be a small business case unless "the court enters an order determining that the committee has not been sufficiently active and representative to provide effective oversight of the debtor" and the debtor meets the statutory small business definition. INTERIM BANKR. R. 1020(c). The U.S. trustee and parties in interest must request such a determination "within a reasonable time" after the committee fails to be sufficiently active and representative to provide oversight. *Id.* The debtor may request such a determination "at any time." *Id.* Objections to a designation and requests for determinations will proceed by motion. INTERIM BANKR. R. 1020(d).

²⁶ BAPCPA § 436, 119 Stat. at 112-13 (to be codified at, and amending, 11 U.S.C. § 1116).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

b. *Enhanced Post-Filing Financial Reporting Requirements for the Small Business Debtor*

BAPCPA requires small business debtors to provide enhanced post-filing financial reports.³⁰ Periodic reports must address profitability,³¹ cash receipts and disbursements, and the status of postpetition tax returns, tax payments, and administrative expense payments.³² The report must also include financial performance projections and a comparison of actual performance to prior projections, and it must indicate whether the debtor is in compliance with all postpetition requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure.³³ The reporting must disclose any noncompliance with reporting requirements, any defaults in tax filing and payment, and whether the debtor is current on the payment of administrative expenses.³⁴ If shortcomings are reported, the debtor must report "how, at what cost, and when" they will be remedied.³⁵

BAPCPA requires the Judicial Conference to develop report forms and related requirements through the rules enactment process.³⁶ BAPCPA also prescribes that the rules and forms be designed to achieve a "practical balance among . . . the reasonable needs of the bankruptcy court, the United States trustee, creditors, and other parties in interest for reasonably complete information;" the debtor's interest that the reports be "easy and inexpensive to complete;" and "the interest of all parties that the required reports help such debtor understand such debtor's financial condition and plan the such [sic] debtor's future."³⁷

c. *Inspections of Books and Records by the U.S. Trustee*

After BAPCPA, the Bankruptcy Code now requires the small business debtor to allow the U.S. trustee, or its designated representative, to inspect the debtor's premises, books, and records "at reason-

³⁰ *Id.* § 434(a), 119 Stat. at 111 (to be codified at 11 U.S.C. § 308).

³¹ "Profitability" is defined as "the amount of money that the debtor has earned or lost during current and recent fiscal periods." BAPCPA § 434(a), 119 Stat. at 111 (to be codified at 11 U.S.C. § 308(a)).

³² *Id.* (to be codified at 11 U.S.C. § 308(b)).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ BAPCPA § 435(a), 119 Stat. at 111-12.

³⁷ *Id.* § 435(b), 119 Stat. at 112.

able times, after reasonable prior written notice" (unless notice is waived).³⁸

d. *Expanded Role of the U.S. Trustee*

In order to enable the U.S. trustee to consider the debtor's viability and business plan early, so that it may explain the debtor's post-filing duties, and so that it may attempt to negotiate a scheduling order, the U.S. trustee is required to conduct an "initial debtor interview."³⁹ On an ongoing basis, the U.S. trustee is to "review and monitor diligently the debtor's activities" so that it may "identify as promptly as possible whether the debtor will be unable to confirm a plan."⁴⁰ If the U.S. trustee finds "material grounds" for relief under § 1112 (dismissal or conversion) of the Bankruptcy Code, it "shall apply promptly" to the court for such relief.⁴¹

e. *Exclusivity and Confirmation for Statutory Small Business Debtors*

Under BAPCPA, statutory small business debtors are provided a 180-day exclusivity period,⁴² and are required to have filed the plan and disclosure statement within 300 days after entry of the order for relief.⁴³ Both deadlines are subject to extension, but the debtor must obtain the extension by motion on notice and hearing.⁴⁴ The order must be "signed" before the deadline expires and must include a new deadline.⁴⁵ In support of the extension motion, the debtor must prove by a preponderance of evidence that "it is more likely than not" that a plan will be confirmed "within a reasonable period of time."⁴⁶ BAPCPA fur-

³⁸ *Id.* § 436, 119 Stat. at 112 (to be codified at 11 U.S.C. § 1116); *see also id.* § 439, 119 Stat. at 113-14 (to be codified at, and amending, 28 U.S.C. § 586(a)) ("[I]f determined to be appropriate and advisable, [the U.S. trustee shall] visit the appropriate business premises of the debtor, ascertain the state of the debtor's books and records, and verify that the debtor has filed its tax returns . . .").

³⁹ BAPCPA § 439, 119 Stat. at 113-14 (to be codified at, and amending, 28 U.S.C. § 586(a)).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)).

⁴³ *Id.*

⁴⁴ BAPCPA § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)).

⁴⁵ *Id.*

⁴⁶ *Id.*

ther mandates that, if the plan complies with Code requirements, the court "shall confirm" the plan "not later than 45 days" after it is filed.⁴⁷

BAPCPA retains the option for a small business debtor to seek conditional approval of its disclosure statement, with final approval to be considered at the confirmation hearing.⁴⁸ And it goes one better: the court may determine that the plan itself contains adequate information so that a separate disclosure statement is not required.⁴⁹ In addition, BAPCPA anticipates the adoption of standard-form disclosure statements⁵⁰ and directs the Judicial Conference to create an official form for small business debtor disclosure statements.⁵¹ Conditional approval of disclosure statements, and combined plan/disclosure statements, will likely become the norm for small business debtors, given that plans are expected to be filed contemporaneously with disclosure statements⁵² and that the existing rules governing all Chapter 11 cases now require twenty-five days' notice for hearings on a disclosure statement's adequacy⁵³ and, thereafter, twenty-five days' notice for plan confirmation.⁵⁴ Without conditional approval, an integrated plan/statement, or motions to shorten time, the preexisting notice requirements simply do not square up with the new statutory requirement that the small business debtor's plan be confirmed or denied within forty-five days of the plan's filing.⁵⁵

f. Restricted Availability of the Automatic Stay

BAPCPA restricts availability of the automatic stay for small business debtors that have had a case dismissed or a plan confirmed within two years of a second filing.⁵⁶ To gain the benefit of the stay, the debtor must prove that the subsequent filing resulted from "circumstances beyond the control of the debtor" and that a nonliquidat-

⁴⁷ *Id.* § 438, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1129).

⁴⁸ *Id.* § 431(2), 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1125(f)(3)).

⁴⁹ BAPCPA § 431(2), 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1125(f)(1)).

⁵⁰ *Id.* (to be codified at, and amending, 11 U.S.C. § 1125(f)(2)).

⁵¹ *Id.* § 433, 119 Stat. at 110-11.

⁵² FED. R. BANKR. P. 3016; INTERIM BANKR. R. 3016(b) (adopted Aug. 22, 2005), available at http://www.uscourts.gov/rules/BK_Interim_Rules_Clean.pdf.

⁵³ FED. R. BANKR. P. 2002(b); FED. R. BANKR. P. 3016.

⁵⁴ FED. R. BANKR. P. 2002(b).

⁵⁵ BAPCPA § 438, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1129).

⁵⁶ *Id.* § 441, 119 Stat. at 114-15 (to be codified at 11 U.S.C. § 362(n)(1)(B), (C)).

ing plan will be confirmed within a "reasonable period of time."⁵⁷ The restriction also applies to an entity that has acquired substantially all the assets of a small business debtor that meets the mentioned criteria, unless it "establishes by a preponderance of the evidence" that it acquired the assets "in good faith and not for the purpose of evading this paragraph."⁵⁸

2. General BAPCPA Provisions of Concern to Small Business Debtors

Taken one at a time, the changes for statutory small business debtors, though considerable, may appear more helpful than not. But they must be viewed in context, and the context includes broader Chapter 11 changes, which apply to all reorganizing entities.⁵⁹

a. *Expansion of Priority for Administrative Claims*

BAPCPA extends administrative priority to accounts payable for goods delivered to Chapter 11 debtors within twenty days of filing⁶⁰ and expands the period for reclamation claims to goods delivered within forty-five days of case commencement.⁶¹ Not only will these changes increase the debtor's administrative debt burden, but they may also serve to frustrate pre-filing cash management strategies.

b. *Assurance of Payment for Utility Service Does Not Include Administrative Expense Priority*

BAPCPA amends § 366 of the Code to require expressly that a debtor's "assurance of payment," which a utility may require in order to continue providing service postpetition, does not include a stipula-

⁵⁷ *Id.* (to be codified at 11 U.S.C. § 362(n)(2)).

⁵⁸ *Id.* (to be codified at 11 U.S.C. § 362(n)(1)(D)).

⁵⁹ We do not attempt encyclopedic recitation of all BAPCPA has wrought for Chapter 11. Rather, we will discuss selected changes that, coupled with the special provisions aimed at the statutory small business debtor, present challenges to the reorganizing small enterprise. *See id.* § 404, 119 Stat. 23, 104-05 (to be codified at, and amending, 11 U.S.C. § 365(d)(4)). Other revisions to Chapter 11—for example the amendment to § 365(d)(4), which requires assumption of nonresidential real estate leases within 120 days of case commencement, subject only to a ninety-day extension without landlord consent—could be problematic for the small business debtor, but are more likely to have substantial impact in cases of large retail chain debtors. *See id.*

⁶⁰ BAPCPA § 1227(b), 119 Stat. at 199-200 (to be codified at, and amending, 11 U.S.C. § 503(b)(9)).

⁶¹ *Id.* § 1227(a), 119 Stat. at 199-200 (to be codified at, and amending, 11 U.S.C. § 546(c)).

tion providing administrative expense priority.⁶² A utility may successfully demand that it be provided assurance in the form of a cash deposit, a letter of credit, a certificate of deposit, a surety bond, or prepayment.⁶³

c. Conversion, Dismissal, and Trustee Appointment

All of the debtor's duties and requirements must be viewed in light of the expanded grounds for conversion or dismissal established by BAPCPA. The new law not only expands the grounds, but it also effects a major change in the burdens of prosecuting and defending such motions—a change that will generate expense and could distract debtors' management, likely at early stages of reorganization.

Pre-BAPCPA, section 1112 of the Code provided a nonexclusive list of grounds for conversion or dismissal of a Chapter 11 case, including: (1) continuing loss to or diminution of the estate, (2) inability to effectuate a plan, (3) unreasonable delay that is prejudicial to creditors, (4) failure to propose a plan by a court-fixed deadline, (5) repeated denials of plan confirmation, (6) revocation of confirmation, (7) inability to consummate a plan in a substantial manner, (8) material default under the terms of a confirmed plan, (9) termination of the plan, and (10) nonpayment of U.S. trustee fees.⁶⁴ BAPCPA adds to the list and amends it to make reference to statutory deadlines for plan confirmation (discussed above).⁶⁵ New grounds for conversion or dismissal include: (1) "gross mismanagement," (2) failure to maintain "appropriate insurance," (3) "unauthorized use of cash collateral substantially harmful to 1 or more creditors," (4) failure to comply with an order of the court, (5) unexcused failure to timely meet reporting requirements, (6) failure to attend the § 341 meeting or a Rule 2004 examination, (7) failure to provide information or attend meetings "reasonably requested" by the U.S. trustee, and (8) failure to "timely" pay postpetition taxes or file tax returns.⁶⁶

⁶² *Id.* § 417, 119 Stat. at 108 (to be codified at 11 U.S.C. § 366(c)(1)(B)).

⁶³ *Id.* (to be codified at 11 U.S.C. § 366(c)(1)(A)).

⁶⁴ 11 U.S.C. § 1112(b) (2000), amended by BAPCPA § 442, 119 Stat. at 115–16 (effective Oct. 17, 2005).

⁶⁵ BAPCPA § 442(a), 119 Stat. at 115–16 (to be codified at, and amending, 11 U.S.C. § 1112).

⁶⁶ *Id.* One might reasonably question how necessary the additional grounds are, given that many (for example, failure to pay postpetition taxes and failure to confirm a plan within a given time) come within existing grounds (for example, continuing loss or diminution and inability to effectuate a plan). Moreover, given that the existing list is non-

The most troublesome aspects of Code § 1112, as amended by BAPCPA, are how it curtails the bankruptcy judge's discretion and how it shifts the burden of proof. Section 1112(b)(1) now provides that, after notice and a hearing,

absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court *shall* convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause.⁶⁷

The new section 1112(b)(4) goes on to identify the nonexclusive list of grounds referred to above as "cause."⁶⁸ Before BAPCPA, section 1112 provided that the court "may" dismiss or convert a case, "whichever is in the best interest of creditors and the estate," if the movant established cause.⁶⁹

These changes are striking in at least two ways. Among the newly identified grounds establishing cause for conversion or dismissal are what could be relatively minor infractions: being a day late or a dollar short on postpetition taxes, missing (or incompletely submitting) a monthly postpetition operating report, using cash collateral for an off-budget emergent expense that results in missing a payment to a lender, or failing to respond adequately to a "request" of the U.S. trustee. Once cause is established, the court is *duty bound* to dismiss or convert the case at the movant's behest, absent "unusual circumstances" demonstrating that conversion or dismissal is not in the best interest of the estate or the creditors.⁷⁰ It may be the case in some instances that conversion or dismissal is a bad idea for all (or substantially all) the case's constituents such that other creditors may spring to the reorganization's defense, but it is far more likely that the debtor will bear the burden of proving up the case against conversion or dismissal. The statute removes the bankruptcy court's discretion in

exclusive, the court now has discretion to order conversion or dismissal for any reason that endangers creditors or the estate, or that imperils constructive reorganization efforts.

⁶⁷ *Id.* § 442, 119 Stat. at 115-16 (to be codified at 11 U.S.C. § 1112(b)(1)) (emphasis added).

⁶⁸ *Id.* (to be codified at 11 U.S.C. § 1112(b)(4)(A)-(O)).

⁶⁹ 11 U.S.C. § 1112(b)(2000), amended by BAPCPA § 442, 119 Stat. at 115-16 (effective Oct. 17, 2005).

⁷⁰ BAPCPA § 442(a), 119 Stat. at 115-16 (to be codified at, and amending, 11 U.S.C. § 1112(b)(2)).

the face of a *prima facie* showing of cause, and it eliminates from the movant's case the burden of demonstrating where the best interests of the estate and the creditors lie. This reflects a legislative judgment that the articulated grounds for cause are in the usual case (absent "unusual circumstances") enough to warrant conversion or dismissal. Among other things, the amendments to § 1112 will embolden disgruntled creditors to make a run at scuttling an infant reorganization. And, in response to each such motion, the debtor will be required to muster proof, at no little expense, of "unusual circumstances" demonstrating that the case should go forward.⁷¹ For smaller debtors, including the statutory small business debtor, whose resources are thin and whose creditor body tends to be less sophisticated, § 1112's new paradigm will be problematic.⁷²

The same grounds that will support dismissal or conversion also constitute cause for appointment of a Chapter 11 trustee "if the court determines that appointment of a trustee or an examiner is in the best interests of the creditors and the estate."⁷³

3. An Assessment: BAPCPA and the Statutory Small Business Debtor

Recall the panoply of duties the statutory small business debtor must now shoulder: reporting, submitting to inspections, and meeting with the U.S. trustee.⁷⁴ As to reporting, no one would argue that it is not important for debtors, and some would say particularly for statutory small business debtors, to assemble and provide reporting regarding their finances as early in the case as possible. And no one

⁷¹ *Id.* (to be codified at 11 U.S.C. § 1112(b)(2)).

⁷² One could argue that the shortened time within which the court must hear (thirty days from filing) and decide (within fifteen days of the hearing's commencement) conversion and dismissal motions, *see id.* (to be codified at 11 U.S.C. § 1112(b)(3)), will keep costs down. Such a motion is the dissatisfied creditor's, or the U.S. trustee's, nuclear weapon. The debtor will have to scramble mightily to meet it, particularly because the burden of proof lies with the debtor. One might also question why a statute should require such a momentous motion to be heard and determined so quickly. The mandated timeframe provides less time for litigation than 11 U.S.C. § 362 provides for relief-from-stay hearings. *Cf. Grella v. Salem Five Cent Savs. Bank*, 42 F.3d 26, 31-35 (1st Cir. 1994) (describing how relief-from-stay disputes must be summarily resolved, given the compressed statutory time limits under which they proceed, and explaining how the orders determining them have limited preclusive effect). The same can be said regarding those BAPCPA provisions that now require a confirmation hearing to convene within forty-five days of plan filing and to be decided within thirty days thereafter. The statute provides the court little leeway (absent complete agreement among the parties) to provide time for discovery, litigation, or negotiation.

⁷³ BAPCPA § 442(b), 119 Stat. at 117-18 (to be codified at 11 U.S.C. § 1104(a)(3)).

⁷⁴ *See supra* notes 23-58 and accompanying text.

would dispute that current reporting of postpetition operations is critically important. But many small business debtors employ outside accountants and bookkeepers for such elementary tasks as payroll and tax filings. No doubt the reporting requirements BAPCPA imposes will increase administrative expenses, either directly or by diversion of in-house manpower.⁷⁵ As to pre-filing reports, the debtor may file a verified statement that the expected reports have not been prepared (or taxes not filed), but that will invite contest, discovery, and more administrative expense. Failure to submit timely post-filing reports constitutes cause for dismissal or conversion (or appointment of a trustee), just as the failure to submit timely, accurate reporting of defaults, as required, provides cause for the same.⁷⁶

It is true that "senior management" should be informed about, and invested in, the reorganization process. But small business managers (often the owners) whose businesses are in financial distress can be expected to be devoting as much time as possible to business operations and related matters, like negotiating for financing. Will it really improve the quality of the reorganization to require them to attend all "meetings" scheduled by the court and by the U.S. trustee? Would the fact that their time and attention would be better spent elsewhere because of their close involvement in day-to-day operations qualify as "*extraordinary and compelling circumstances*" to excuse their attendance, given that their circumstances might well be quite ordinary for their business and similar businesses? Should the debtor be required to file a motion (generating more counsel fees) to obtain a "waiver" from the attendance requirement?

It remains to be seen how the U.S. trustee's expanded role in the statutory small business case will work out. Certainly, BAPCPA expects (and requires) a great deal from the U.S. trustee. But how will an early U.S. trustee assessment that the reorganization is not "viable" be greeted by the court and by creditors (whose wallets are actually in the case) that have not yet assessed the situation for themselves? To expect deference to the U.S. trustee's judgment and recommendations at such an early juncture is expecting a lot. And, again, contest-

⁷⁵ We have yet to compare the new, monthly financial report to the monthly operating statement provided by the U.S. trustee before BAPCPA, but the statutory requirements that the new report include projections, compare actual performance to past projections, and report "profitability" would lead to the conclusion that the new report will be substantially more elaborate than the old.

⁷⁶ BAPCPA § 442(a), 119 Stat. at 115-16 (to be codified at, and amending, 11 U.S.C. § 1112(b)(4)(F)).

ing any U.S. trustee action or recommendation will cost the debtor in administrative expense.

Under BAPCPA there is much fodder for conversion, dismissal, and trustee appointment motions. Defending those motions requires much of the debtor. The automatic stay, once a given, may not apply (or there will be litigation regarding its application) in small business cases where there has been a prior bankruptcy.⁷⁷ Reporting requirements and attendance requirements also will cost debtors. At the same time, many debtors will face other new, large administrative expenses in light of the utility deposit,⁷⁸ the forty-five-day reclamation claim period,⁷⁹ and the delivery-within-twenty-days administrative expense rule.⁸⁰

BAPCPA does have some positive attributes. It plainly authorizes, and directly encourages, the increased use of status conferences.⁸¹ The possibilities for conditional approval of disclosure statements (or of forgoing them altogether) can expedite the confirmation and reduce costs. Permitting plan solicitation consistent with lawful prebankruptcy activities⁸² may be helpful to some debtors, and small business debtors will welcome the expanded 180-day exclusivity period that BAPCPA provides.⁸³

In our view, however, the net result for small businesses in Chapter 11, statutory small businesses, and others, will be increased litigation and administrative expense early in the case and increased likelihood that the small business debtor will not survive the cure for its financial ills. For a debtor with all its ducks in a row before filing, BAPCPA may offer a quick trip to confirmation and beyond. But for the larger share of small business debtors, those upon whom the enormity of their distress dawns late and those who do not know how many ducks they have, let alone how to line them up, BAPCPA's "reformed" reorganization process will prove daunting. The "breathing space" historically pro-

⁷⁷ *Id.* § 441(2), 119 Stat. at 114-15 (to be codified at, and amending, 11 U.S.C. § 362(n)(1)).

⁷⁸ *Id.* § 417, 119 Stat. at 108 (to be codified at, and amending, 11 U.S.C. § 366(b), (c)).

⁷⁹ *Id.* § 1227(a), 119 Stat. at 199-200 (to be codified at, and amending, 11 U.S.C. § 346(c)).

⁸⁰ *Id.* § 1227(b), 119 Stat. at 200 (to be codified at, and amending, 11 U.S.C. § 303(b)).

⁸¹ BAPCPA § 440, 119 Stat. at 114 (to be codified at, and amending, 11 U.S.C. § 105(d)). The amendment to Code § 105(d)(1) effected by BAPCPA's § 440 can be characterized as a toothless tiger. *See id.* Section 105(d)(1)'s new direction to the court is to "hold such status conferences as are necessary to further the expeditious and economical resolution of the case." *Id.*

⁸² *Id.* § 408, 119 Stat. at 106 (codified at 11 U.S.C. § 1125(g)).

⁸³ *Id.* § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)(1)).

vided by bankruptcy will be reduced to a "panting space," without real opportunity for the debtor to catch its breath and move forward. Moreover, pre-filing actions taken to prepare for bankruptcy may trigger creditor response in the form of involuntary petition, and those thrown into the small business reorganization stew involuntarily and without adequate preparation will find the going treacherous.

II. PRACTICAL SUGGESTIONS FOR NAVIGATING THROUGH THE SWAMP

Seventy-five percent of the 1465 American Bankruptcy Institute members responding to a 1996 survey came to some unsurprising conclusions with respect to small business Chapter 11 cases.⁸⁴ The following comprise three anchors of the survey results:

- (1) An attempt should be made to make it easier for small business debtors to preserve a fresh start;
- (2) An effort should be made to enhance distribution to creditors; and
- (3) Delays in administration and excessive professional fees and expenses should be avoided.⁸⁵

These findings facially appear no more controversial than motherhood and apple pie. Upon further reflection, however, there is an inherent inconsistency between preserving a fresh start and enhancing distribution to creditors. Where do you draw the line to prevent an inequity to one constituency in a case, as opposed to (and often at the expense of) another? The solution is not new: the courts must act as the ultimate arbiter. The task is to weigh the various factors that are relevant in every small business case, including the debtor's background, the adequacy of the debtor's books and records, and the likelihood that confirmation of a plan will not be followed shortly by another bankruptcy filing.

Looking at the existing small business chapter and the new small business amendments contained in BAPCPA, one questions whether Congress has achieved a fair balance between the rights of creditors and the rights of debtors. If anything, the pendulum appears to have swung in the direction of secured creditors. Undersecured creditors

⁸⁴ See AM. BANKR. INST., REPORT ON THE STATE OF THE AMERICAN BANKRUPTCY SYSTEM (1996), http://www.abiworld.org/Content/NavigationMenu/News_Room/Research_Center/Bankruptcy_Reports_Research_and_Testimony1/ABI1/Report_on_the_State_of_the_American_Bankruptcy_System.htm.

⁸⁵ See generally *id.*

with large deficiency claims have always carried a big club in small business bankruptcies, by virtue of their ability to block the general unsecured class's acceptance of a proposed plan.⁸⁶ The new mandatory reporting requirements for small business debtors,⁸⁷ in addition to mandatory conversion or dismissal for a number of events deemed "cause" (not the least of which is the "unauthorized" use of cash collateral),⁸⁸ stacks the deck even further in favor of secured creditors, which tend to have sufficient financial and professional resources to bring the debtor's shortcomings to the bankruptcy court's attention early in the case.

Against this backdrop, it appears that in order to achieve a successful reorganization of small businesses, debtors' counsel will need to become more imaginative. Now more than ever, there is an extraordinary need to think "outside the box" to achieve a favorable result for one's client. Counsel must be prepared to pursue and implement alternative remedies well in advance of the filing of a case. The game plan may change midstream, but one thing is a given: the more time counsel has to evaluate the debtor client's ability to achieve a successful reorganization, the better the chance of success.

The 1994 amendments imposed limited exclusivity and short-term limitations on small business debtors attempting to confirm a plan.⁸⁹ It is, therefore, understandable that experienced bankruptcy counsel have avoided using the small business statutory scheme. Unfortunately, Congress has now mandated that almost all businesses that seek Chapter 11 relief with secured and unsecured debts of less than two million dollars use the small business provisions.⁹⁰ Congress, perhaps unintentionally, failed to recognize that "small business" today encompasses much more than the ubiquitous mom-and-pop enterprises. The word "large" is not a defined term in the Bankruptcy Code. A "large" case in today's parlance, however, is considered by most bankruptcy profes-

⁸⁶ See 11 U.S.C. § 1126(c) (2000) (defining "acceptance" of plan by a class of creditors to require approval of holders of two-thirds in dollar amount, and more than half in number, of claims held by the class).

⁸⁷ BAPCPA, Pub. L. No. 109-8, § 434, 119 Stat. 23, 111 (to be codified at 11 U.S.C. § 308(b)).

⁸⁸ *Id.* § 442, 119 Stat. at 115-16 (to be codified at, and amending, 11 U.S.C. § 1112(b)).

⁸⁹ Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 217(d), 108 Stat. 4106, 4127 (codified as amended at 11 U.S.C. § 1121(e)).

⁹⁰ See BAPCPA § 432, 119 Stat. at 110 (to be codified at 11 U.S.C. § 101(51D)) (defining "small business debtor" as any debtor that falls beneath the debt ceiling, in a case where there is no meaningful committee oversight).

sionals to be a public corporation having several millions of dollars of layered secured and unsecured debt, with operations in several locations. The preservation of hundreds, if not thousands, of jobs is at stake in such cases. What is missing from both the prior amendments to the Code and the BAPCPA amendments is a viable process for the rehabilitation of small entities with unsophisticated financial structures and, most often, an unenergized creditor constituency.

A. Thinking Outside the Box

1. Pragmatism Should Prevail: Think Before You File

With the proliferation of lawyers in general, many of the smaller cases today are handled by less-than-experienced counsel. There is little incentive for an experienced bankruptcy boutique or large firm with a bankruptcy department to handle these matters. They are simply not economical. This is unfortunate for small business clients, many of whom end up in a Chapter 11 they cannot afford, often on the advice of counsel who lacks the experience and expertise to appreciate the nuances of small business bankruptcy. Attorneys should be careful not to develop a “file first, think later” mentality, especially because of the inherent conflict between the attorney’s desire to generate legal fees and the client’s need for an expeditious and cost-effective resolution. A Chapter 11 filing motivated by the attorney’s desire for pecuniary gain, however slight, is a particularly insidious breach of professional ethics—capable of repetition, yet evading review. Often the best and least expensive legal advice (though not always the easiest for the client to swallow) is that there is no purpose in attempting to reorganize, and thus nothing to be gained by a Chapter 11 filing.

2. Alternatives to Cash Retainers for Legal Fees

Most lawyers willing to handle a Chapter 11 case require a substantial retainer before filing. Ironically, this payment often serves to rob the small Chapter 11 debtor of the cash it requires in order to procure raw materials and other services necessary for its survival. This situation brings the inherent conflict of interest between attorney and small business client to the forefront. To be sure, retainers are a tried-and-true staple of any insolvency practice. If a cash retainer threatens the client’s prospects for reorganization, however, counsel should consider alternative means of obtaining payment of legal fees—for example, from an outside, third-party source such as a family member of the client, or by means of a security interest in under-

encumbered assets of the business. If a retainer using the "life blood" cash of the business is the only way to go, then counsel should be all the more certain that Chapter 11 is appropriate.

3. Energizing Languid Creditor Committees

Few bankruptcy lawyers used the 1994 small business provisions, as there were simply no tangible benefits to the debtor. With the BAPCPA amendments, however, small business treatment is mandatory if the court determines that the creditors' committee is "not sufficiently active and representative to provide effective oversight of the debtor."⁹¹ Counsel can no longer avoid the small business provisions by opting out, so they will need to be more proactive in assisting the formation of an active creditors' committee. This will be no easy task. There is typically very little creditor interest in small business cases; it approaches apathy. Trade creditors, as the result of years of frustration in no-asset cases, tend to write off the debts of small businesses that file for Chapter 11 protection. Except in rare cases, usually involving substantial assets, creditors take no active involvement in committee activities. Energizing such a languid creditor body will require substantial prebankruptcy planning, some creativity, and more than a little cheerleading. If it is done right, however, the small business debtor may be able to request creditors with which it has enjoyed a fairly prolonged relationship to act as members of a prepetition committee. This may result in significant time and cost savings.⁹²

4. An Active Creditor's Committee Is Preferable to Heightened Oversight from the U.S. Trustee

Attempting to put together a committee prepetition to ensure active committee participation should also serve to mitigate the harshness

⁹¹ *Id.*

⁹² See 11 U.S.C. § 1102(b)(1) (2000) (allowing a prepetition committee to serve as the official committee if it was "fairly chosen" and is "representative of the different kinds of claims to be represented"). Another advantage to selecting one's own committee prepetition is the possibility of excluding industry competitors from the group of creditors who will be receiving detailed, firsthand information about the debtor's business operations. Although the bankruptcy court has the ability to protect against the disclosure of trade secrets, see 11 U.S.C. § 107(b)(1) (2000), and to order a change of committee membership when necessary "to ensure adequate representation of creditors" (for example, by excluding a potential committee member who has an interest materially adverse to the estate), BAPCPA § 405, 119 Stat. at 105 (to be codified at 11 U.S.C. § 1102(a)(4)), it can exercise those powers only on motion by a party in interest, and after notice and a hearing.

of BAPCPA's U.S. trustee provisions. The lack of committee participation in smaller cases usually invites heightened U.S. trustee oversight, which can result in distractions from the debtor's day-to-day business activity. Under BAPCPA, the problem certainly will be exacerbated because the U.S. trustee is obligated to evaluate small business debtors' financial viability;⁹³ even highly experienced professional financial consultants might have a tough time fulfilling that mandate! Although time will tell, it seems that with all of these additional duties, the U.S. Trustee's office should have little interest in overseeing the debtor's operations that appear adequately looked-after by an active creditors' committee. Active participation by creditors, who have a concrete stake in the outcome of the case, should be reassuring to the Office of the U.S. Trustee. Moreover, appointment of an official creditor's committee will take the debtor directly out of the statutory small business category.

5. Increased Participation of Judges Through Frequent Status Conferences

Bankruptcy judges today have handled a wide variety of small business cases that have some promise for emerging from Chapter 11. They have substantial business savvy. Judges are capable of discerning rather quickly when, and if, conversion or dismissal is in the best interest of all parties. They are also familiar with the ability and trustworthiness of the lawyers appearing before them. Under these circumstances, bankruptcy judges hopefully will play a more proactive role in determining the direction of a small business case from its inception. They can accomplish this by using frequent status conferences, both to acquire a feel for the severity of the problems and to set appropriate deadlines for their resolution. Indeed, § 105(d) of the Code now *requires* the bankruptcy court to hold "such status conferences as are necessary to further the expeditious and economical resolution of the case," though the qualifying language "as are necessary" obviously affords the judge wide latitude in determining whether, when, and how often to hold such conferences.⁹⁴ The need for judicial discretion in small business cases is great. But, as explained above, BAPCPA has re-tooled important provisions relating to such critical events as conversion, dismissal, trustee appointment, and

⁹³ BAPCPA § 439, 119 Stat. at 113-14 (to be codified at 28 U.S.C. § 586(a)(7)).

⁹⁴ See *id.* § 440, 119 Stat. at 114 (to be codified at, and amending, 11 U.S.C. § 105(d)). Prior to BAPCPA, the use of section 105(d) status conferences was discretionary.

confirmation, reducing or removing the judge's discretion in such matters.⁹⁵

6. The Social Benefit of Helping Small Businesses to Survive

There is unmistakably a social purpose that is served by providing some slack to small business debtors. It has been said that the first principle of bankruptcy law is that the insolvent debtor always gains from more time: "Liquidate today and he loses everything, wait until tomorrow and something may turn up."⁹⁶ The typical Chapter 11 case provides an invaluable opportunity for a small business debtor to remain in operation, either in its present form or by the creation of a new entity in the event of conversion or dismissal. This makes sense. Saving jobs in small business enterprises, which are disappearing with alarming frequency, may be essential to the preservation of the American way of life. Competition and convenience disappear without them. We know this from common experience in the retail industry. When the small, local business disappears, consumers are left largely with the regional megastores. Less competition usually results in higher prices and poorer service.

B. *A Plan for Balancing the Priorities*

1. Eliminate the Disclosure Statement Requirement for Cases Under \$10 Million

To the extent possible under the Code, the courts must establish new local practices to achieve, economically, the primary goals of the bankruptcy system. Ideally, the disclosure statement requirement in cases under \$10 million should be eliminated.⁹⁷ Does anyone, other than the few professionals involved in the case, read them? Congress, to its credit, has seen fit possibly to eliminate the disclosure statement requirement altogether in cases under \$2 million.⁹⁸ This approach should be modified or expanded to include larger entities.

⁹⁵ See *supra* notes 67-73 and accompanying text.

⁹⁶ See John D. Ayer, *The New Face of Douglas Baird*, 12 AM. BANKR. INST. L. REV. 101, 107 (2004).

⁹⁷ See 11 U.S.C. § 1125(b).

⁹⁸ See BAPCPA § 431, 119 Stat. at 109-10 (to be codified at, and amending, 11 U.S.C. § 1125(f)).

2. Confirm Plans That Include Alternative Provisions Triggered by the Debtor's Post-Confirmation Performance

The quality of proof required from a small business debtor in a contested confirmation hearing on the issue feasibility under § 1129 of the Code should be relaxed, particularly in "first time around" cases.⁹⁹ Counsel should proffer plans with alternative provisions, which may come into effect based on the debtor's post-confirmation performance and other conditions. A plan that takes future development and defalcations into account via "fallback" provisions can more readily be considered feasible at confirmation.

3. Permit Prepetition Security Interests to Substitute for Prepetition Retainers

Counsel for smaller business debtors should be afforded the flexibility to structure the payment of their legal fees without taking large retainers prepetition. Where it is otherwise reasonable, counsel's prepetition security interest in unencumbered or under-encumbered assets of the estate should be respected in bankruptcy unless it presents a genuinely adverse interest to the estate. The First Circuit Court of Appeals sanctioned this approach in 1987,¹⁰⁰ and a number of lower courts nationwide have followed its lead.¹⁰¹ Carve-outs from secured

⁹⁹ See 11 U.S.C. § 1129(a)(11) (2000). Compare *Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters.* (*In re Briscoe Enters.*), 994 F.2d 1160, 1165 (5th Cir. 1993) (applying preponderance standard), with *In re New Midland Plaza Assocs.*, 247 B.R. 877, 883 (Bankr. S.D. Fla. 2000) (applying clear and convincing standard), *aff'd sub nom.* *Alcoa Calderwood LLC v. New Midland Plaza Assocs.* (*In re New Midland Plaza Assocs.*), 296 F.3d 1301 (11th Cir. 2002) (table decision), *withdrawn*, 2003 U.S. App. LEXIS 17794 (Aug. 15, 2002).

¹⁰⁰ See *In re Martin*, 817 F.2d 175, 181-83 (1st Cir. 1987) (holding that a case-by-case analysis is necessary to determine whether a security interest in estate property is an interest "adverse to the estate" within the meaning of 11 U.S.C. § 327(a)).

¹⁰¹ See *In re Mall*, 2004 Bankr. LEXIS 1414, at *15-18 (Bankr. D. Kan. July 28, 2004); *In re Huntco Inc.*, 288 B.R. 229, 234-35 (Bankr. E.D. Mo. 2002); *Weinman, Cohen & Niebrugge, P.C. v. Peters* (*In re Printcrafters, Inc.*), 233 B.R. 113, 120 (D. Colo. 1999); *In re City Mattress, Inc.*, 163 B.R. 687, 688-89 (Bankr. W.D.N.Y. 1994); *Meeker v. Germeraad* (*In re Quincy Air Cargo, Inc.*), 155 B.R. 193, 196 (Bankr. C.D. Ill. 1993); *In re Gilmore*, 127 B.R. 406, 409 (Bankr. M.D. Tenn. 1991); *Michael v. Carter* (*In re Carter*), 116 B.R. 123, 127 (E.D. Wis. 1990); *In re K&R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989); *In re Shah Int'l, Inc.*, 94 B.R. 136, 138-39 (Bankr. E.D. Wis. 1988); *In re Watson*, 94 B.R. 111, 116 (Bankr. S.D. Ohio 1988); *In re Automend, Inc.*, 85 B.R. 173, 176-78 (Bankr. N.D. Ga. 1988); see also *In re BH&P Inc.*, 949 F.2d 1300, 1312-13 (3d Cir. 1991) (citing *In re Martin* with approval in an analogous matter of trustee disqualification); *In re Diamond Mortgage Corp. of Ill.*, 135 B.R. 78, 92 (Bankr. N.D. Ill. 1990) (citing *In re Martin* with approval in dictum). But see *In re Fulgham Enters., Inc.*, 181 B.R. 139, 142 (Bankr. N.D. Ala. 1995) (adopting a per se rule that attorneys are not "disinterested" when they are creditors of the

creditors' collateral seem to be almost routine in larger cases and should continue to be used.¹⁰²

4. Use § 305(a)(1) Abstention Powers More Liberally

Bankruptcy courts should use their abstention powers under section 305(a)(1) of the Code more liberally after the filing of an involuntary petition, particularly when there is likely no benefit to creditors in disturbing an out-of-court workout pursuant to an assignment for the benefit of creditors, a receivership, or a composition agreement. Preference issues are of little concern in many small business bankruptcies, as the debtor has usually been working on a C.O.D. or C.B.D. basis with its suppliers long before the involuntary petition is filed.

5. Negotiate Forbearance Agreements and Moratoria with Creditors Before Filing

Debtors increasingly have the ability to negotiate forbearance agreements with secured creditors. They may also seek a voluntary moratorium from trade creditors, albeit for limited periods of time, outside of bankruptcy. Grace periods recommended by prepetition creditor committees have been particularly successful. Assuming there is a gestation period before the filing of a Chapter 11 case, debtor's counsel may be able to work out a payment plan acceptable to a small, but *active*, unofficial committee. This often can be the foundation for a formal plan of reorganization, which can be filed simultaneously with the Chapter 11 petition.¹⁰³ This certainly has a tendency to shore up creditor confidence, and it may prevent serious erosion in business from predatory competitors.

6. Small, Closely Held Corporations May Reorganize Under Chapter 13

It may be feasible in some cases for a "micro" business debtor, operating as a closely held corporate entity, to dissolve the corporation and assume the business debt as a sole proprietor. It is then pos-

estate); *In re Escalera*, 171 B.R. 107, 113 (Bankr. E.D. Wash. 1994) (same); *In re Eastern Charter Tours*, 167 B.R. 995, 996-97 (Bankr. M.D. Ga. 1994) (same).

¹⁰² See Baird, *supra* note 6, at 83 n.60. Apparently the practice of carve-outs from secured creditors' collateral, at least in cases large enough to require debtor-in-possession lending, is so commonplace as to be regarded as "the price of admission to the bankruptcy court." *Id.*

¹⁰³ 11 U.S.C. § 1121(a).

sible for the individual to use the less onerous Chapter 13 provisions for a plan.¹⁰⁴ This has been an effective tool in several cases in the District of Maine.¹⁰⁵

7. Limit the Use of Independent Accountants for Creditors' Committees

Courts have the ability to limit the number of professionals in smaller cases.¹⁰⁶ Is there always a need for a committee in a small business case to use its own accountant or financial advisors when the total liabilities are small? A court has the ability under § 105(a) to order the debtor's accountant to provide to a creditors' committee all information generated for the debtor or the U.S. trustee.¹⁰⁷

8. Judges Should Exercise Discretion When Approving Counsel's Fees

A court has the ability by local rule to increase the threshold on the amount of fees that must be individually categorized in a Chapter 11 fee application.¹⁰⁸ The cost of preparing categorized applications is perhaps out of proportion to the benefits, if any, to be obtained in small cases. Certainly, judges have the ability to pass judgment on the skill of the professionals involved in a case and to make decisions that are reasonable and fair to counsel when the services and expenses are detailed in the fee application.

9. Standardization of Disclosure Statements Utilizing Local Rules

When disclosure statements are required, it would be helpful to adopt a standard form under local rules, which will greatly eliminate the usual contentiousness (much of which is petty) and the need for

¹⁰⁴ See 11 U.S.C. § 1325 (2000), amended by BAPCPA §§ 107, 213, 306, 309, 318, 716, 119 Stat. at 33–35, 53, 80, 83, 93–94, 129. In Chapter 13, creditors do not vote on the plan. Instead, the court determines whether the Chapter 13 filing and proposed plan were in good faith, whether the plan is feasible, and whether the plan satisfies the “best interests” test by providing all claimants with property of a value (over time) at least equal to what they would receive in a hypothetical liquidation.

¹⁰⁵ See, e.g., *In re Bois*, No. -0-22751 (D. Me. filed Oct. 14, 2005); *In re Smith*, No. 02-20292 (D. Me. filed Mar. 4, 2002); *In re Kinsey*, No. 97-20160 (D. Me. filed Feb. 7, 1997); *In re Dion*, No. 96-21408 (D. Me. filed Sept. 12, 1996); *In re Beaudoin*, No. 96-02224 (D. Me. filed Sept. 1, 1996).

¹⁰⁶ See 11 U.S.C. § 327(a) (requiring court approval to employ professionals in a case).

¹⁰⁷ See 11 U.S.C. § 105(a) (permitting the bankruptcy court to “issue any order . . . that is necessary or appropriate to carry out the provisions of” the Bankruptcy Code).

¹⁰⁸ See 11 U.S.C. § 330 (providing court discretion to award or deny fees, and to reduce requested fees), amended by BAPCPA §§ 232, 407, 415, 1104, 119 Stat. at 74, 106, 107, 192.

hearings and re-hearings on the issue of adequacy of disclosure under § 1125(a)(1) of the Code. BAPCPA anticipates development of standard forms.¹⁰⁹

10. Encourage Solicitation of Plan Approval Prepetition

In small cases, courts should now be able to make it easier for debtors to solicit acceptances of a plan prepetition. A court has the ability to review the nature and extent of pre-filing solicitation and can order the debtor to provide notice to creditors of misleading or incorrect information.¹¹⁰ It can punish lawyers for their roles if abuses occur.¹¹¹ To minimize the potential for abuse, debtors should be required to maintain records and copies of all solicitation materials.

III. EXPANSION OF CHAPTER 12 TO INCLUDE ALL SMALL BUSINESS DEBTORS

Chapter 11's one-size-fits-all paradigm does not produce efficient results when applied to "small businesses," however that term may be defined. Reasonable minds differ, however, as to what can be done to ensure the proper functioning of the system in the future.

Apparently the National Bankruptcy Review Commission and the 109th Congress believed that the key to meaningful reform was to erect barriers to ensure that only the worthiest small business debtors make it past the early stages of a Chapter 11 case.¹¹² Unfortunately, this approach focuses merely on curbing perceived abuses of the existing system and fails to address the fact that Chapter 11 is generally inhospitable to even the most deserving of small business debtors.

Public companies and small businesses are like apples and oranges, and we need an entirely separate chapter (Chapter 10) to deal with small business bankruptcies. But Congress has consistently rejected this proposal. This rejection comes partially out of fear that having two business chapters with different substantive rules would provoke the same kind of wasteful litigation that Congress sought to prevent when it collapsed Chapters X and XI of the 1898 Bankruptcy Act into Chapter 11 of the Code, enacted through the Bankruptcy Reform Act of 1978.

¹⁰⁹ BAPCPA § 433, 119 Stat. at 110-11.

¹¹⁰ See 11 U.S.C. § 1125 (2000) (outlining disclosure and solicitation requirements), amended by BAPCPA §§ 408, 431, 717, 119 Stat. at 106, 109-10, 131.

¹¹¹ FED. R. BANKR. P. 9011.

¹¹² See NAT'L BANKR. REVIEW COMM'N, *supra* note 16, at 612-13.

Alternatively, rather than enact a new chapter, Congress could increase the debt ceilings for Chapter 13 and Chapter 12 so that more sole proprietors and farming corporations, respectively, can avail themselves of their provisions. Indeed, Congress made just such an adjustment in 1994 as part of its general small business bankruptcy reform. But casting a wider net with the hope of rescuing *more* (but not *all*) small business debtors from the perils of Chapter 11 leaves us with a rather schizophrenic system that draws very meaningful distinctions along rather arbitrary lines—specifically, the debtor's choice of business entity. Thus, under the current regime, the rule could be stated as follows: a debtor who does business as a sole proprietor may use Chapter 13 or Chapter 11 unless the debtor has too much debt, in which case he or she must use Chapter 11, but a debtor who does business in corporate form (or as a partnership) must use Chapter 11, unless it is a farm (or fishing enterprise) without too much debt, in which case it may use Chapter 12.

The future of small business bankruptcy lies not in raising the debt ceilings for Chapters 12 and 13, but rather in substantively expanding Chapter 12, with some modification, to include closely held business corporations and partnerships. This approach makes sense for several reasons.

The overwhelming majority of ABI members who responded to the 1996 survey reported that excessive delays and excessive professional fees were the most serious impediments to the successful use of Chapter 11 by small business entities.¹¹³ A majority of the ABI respondents opposed the appointment of an independent financial advisor in reorganization cases to analyze and provide information to the court and creditors concerning the debtor's financial condition and viability. Finally, ABI members strongly supported the "cramdown" power and the "new value exception" to the absolute priority rule.¹¹⁴ In fact, eighty percent of those polled—debtors' and creditors' attorneys alike—supported the proposition that the bankruptcy court should be able to confirm a plan even though no impaired class accepts it.¹¹⁵

Chapter 12, a close cousin to Chapter 13, offers an economical alternative to Chapter 11. Consider the following:

1. Chapters 12 and 13 are tried and tested. The checks and balances between debtor and creditor interests seem to work well, and

¹¹³ See AM. BANKR. INST., *supra* note 84.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

there have been few complaints of substantial abuse by any constituency.

2. Initially, problematic issues, such as what constitutes "disposable income" under sections 1225 and 1325 of the Code or what constitutes "property of the estate" under sections 1207 and 1306, are now fairly well-settled under caselaw. The availability of this body of caselaw interpreting the provisions of Chapters 12 and 13 should allay some of the fears that drove Congress to reject the enactment of Chapter 10—namely, that a new chapter would add unnecessary complexity to the Bankruptcy Code, and would generate more than its fair share of litigation as the contours of the new chapter were explored by parties and their counsel.

3. Chapter 13 trustees are already experienced in dealing with business cases involving sole proprietors. Chapter 12 trustees already have substantial experience administering business cases involving family farming corporations, many of which concern business operations that are far more complex than those of most small corporate debtors. Thus, whether the U.S. Trustee's office appoints a standing trustee to administer Chapter 12 small business cases or appoints a panel trustee in each small business case, the trustees ought to be able to handle the new responsibility with limited additional training and with help from business analysts from the U.S. Trustee's office.

4. As previously discussed, and as U.S. trustees and administrators can attest, little creditor interest exists in small business cases. Only a small number of cases evoke sufficient interest to form an active creditors' committee. From experience, creditors believe (with good reason) that the ultimate "payout" in a case simply will not justify any investment of their time. In a small business Chapter 12 case, the trustee would look after the interests of creditors. Under appropriate circumstances, the trustee could oust the debtor from possession and seek conversion or dismissal, or some other remedy on behalf of the creditors.

5. The absence of an active creditors' committee in smaller cases historically imposed a substantial burden on the U.S. trustee to monitor these cases in the public's interest. BAPCPA increases this burden significantly. Given that the U.S. trustee already bears such a burden, the additional responsibility created by an increase in the number of Chapter 12 cases should not be significant.

6. Even when disclosure statements are approved and plans are filed in small business Chapter 11 cases today, relatively few unsecured creditors bother to cast ballots either for or against a plan. Depriving creditors of the vote in a small business Chapter 12 proceeding logi-

cally should not bring cries of alarm, especially given the amount of oversight provided by the U.S. trustee.

7. As noted by the NBRC, most small business Chapter 11 cases fail, although they typically die a lingering death.¹¹⁶ As they filter through the system, substantial administrative fees and expenses are paid to the professionals. When the well runs dry, the cases die from dehydration. When they finally convert to Chapter 7, the unsecured creditors rarely receive a dividend. Because creditors do not vote on Chapter 12 plans, a Chapter 12 small business case would not generate the kind of administrative expenses (for example, creditors' committee counsel and plan solicitation materials) that are common in Chapter 11. This, combined with the accelerated timeline of Chapter 12, would mean that more assets would be available to creditors if the Chapter 12 reorganization failed and was followed by a Chapter 7 liquidation.

8. The absolute priority rule in a small business case offers little real protection to creditors. This is true even using the budding practice evolving from the dictum provided by the Seventh Circuit Court of Appeals in the 1997 case *In re 203 North LaSalle Street Partnership*.¹¹⁷ Is it relevant to creditor interests whether the reorganization plan of an electrician with four employees offers others an equal chance to purchase the "equity" of the debtor corporation? Realistically, the market for this equity is "virtually nonexistent" because most companies have little or no value after their owner-managers have been ousted by the hypothetical high bidder.¹¹⁸

These facts suggest that closely held corporations and other business entities are good candidates for Chapter 12 using conservative debt thresholds such as those applicable to Chapter 13 debtors. So, for instance, a corporation or other business entity would qualify for Chapter 12 relief if its noncontingent, liquidated, unsecured debts were less than \$307,675 and its noncontingent, liquidated, secured debts were less than \$922,975.¹¹⁹ This criterion creates a bright-line test for eligibility.

A significant number of all potential reorganization cases might qualify for Chapter 12 treatment. Although a debtor probably would not choose Chapter 11 over Chapter 12 (except for purposes of delay, which BAPCPA seems to have eliminated), Congress should make

¹¹⁶ See NAT'L BANKR. REVIEW COMM'N, *supra* note 16, at 613-14.

¹¹⁷ See 126 F.3d 955, 963-67 (7th Cir. 1997).

¹¹⁸ LoPucki, *supra* note 9, at 758.

¹¹⁹ See 11 U.S.C. § 109(e) (2000).

Chapter 12 mandatory for corporate and other business entities with the exception of sole proprietorships, which would still be able to use Chapter 13. A two- or three-year sunset provision would create closure if the Chapter 12 provisions failed to provide the speedy, equitable and efficient results intended.

Congress did not contemplate general business entities when it enacted Chapter 12. Consequently, allowing general business entities to seek Chapter 12 relief would require some modification to prevent debtors from abusing the present statutory scheme. For instance:

1. A corporation or other business should not be able to dismiss a case as of right under § 1208(b). The court should allow dismissal only "for cause" and after notice and a hearing.

2. Small business entities should be entitled to a discharge or a permanent injunction against enforcement of prepetition dischargeable debt upon successful completion of plan payments. Granted, a Chapter 11 discharge kicks in at the moment of confirmation because the debtor needs to finalize its debt structure forevermore. But small businesses traditionally do not have the same pressure for constant financing and refinancing. Moreover, actual receipt of plan payments should be viewed as the quid pro quo for the relinquishment of creditor voting rights. Thus, there should be a delay in the granting of a discharge in small business cases until the debtor has completed payments under the plan.

3. A business should have sixty days to file a plan and another sixty days to obtain its confirmation.¹²⁰ The court should extend these deadlines only for cause shown.

4. A business debtor should be required to file a mini-disclosure statement with the court at least fifteen days before the confirmation hearing. The disclosure statement should include monthly cash flow and profit and loss projections for one year following the date set for confirmation of the plan. This would afford the creditors a reasonable opportunity to formulate objections to the debtor's proposed plan before the confirmation hearing, and it would serve as the quid pro quo for excluding creditors from voting and oversight of the debtor through committee membership.

5. Chapter 12 should not require a business debtor to pay secured creditors and post-confirmation business debts through the Chapter 12 trustee, even though payments emanate from future in-

¹²⁰ Cf. 11 U.S.C. § 1221 (providing ninety days to file a plan).

come generated by the debtor in the normal course of business. This would involve amending § 1222(a)(1).

6. A fair-market standard should govern valuation of a business entity's real estate. That would produce an equitable result, given that undersecured creditors in Chapter 12 would lose both their right to make the § 1111(b) election and any opportunity to vote against the debtor's plan or to propose a plan of their own.

7. Chapter 12 should empower the U.S. trustee, with leave of court, to pursue claims against principal officers or other insiders of a corporate or general partnership debtor.

8. Congress should expand the U.S. trustee's right to commence an action against third parties to three years after confirmation of the debtor's plan.

9. A business debtor should not be able to invest in new equipment, machinery, business vehicles, or other capital assets during the pendency of the case without the U.S. trustee's prior authorization. In the event the parties fail to reach an agreement, the courts should review the U.S. trustee's decision to withhold authorization *de novo*.

10. Single-asset real estate entities, as defined under § 101(51B), should not qualify for Chapter 12 relief.

11. Congress must relax § 327(a)'s strict disinterestedness requirements for debtor representation in small entity cases. The Code should not disqualify a professional from representing a debtor merely because of existing, unpaid prepetition fees and expenses. Prior representation of a creditor in an unrelated matter against the debtor also should not disqualify the professional from such representation. Absent an actual conflict of interest, a professional should be permitted to represent a corporate or other business debtor in Chapter 12 cases. Disqualification should not be automatic.

12. Congress should amend § 1201(a) to prevent a Chapter 12 business entity from having the ability to convert to Chapter 11.

13. Congress should amend § 1208 to provide that, after conversion or dismissal, a Chapter 12 small business entity may not file another case under this chapter for a period of three years from the date of the confirmation or dismissal.

14. Congress should amend § 303(a) and (b) to permit involuntary Chapter 12 petitions against closely held corporations and other debtors engaged in business.

This proposal, in much the same form, was presented to—and almost summarily rejected by—the NBRC.¹²¹ The Commission concluded that Chapter 11 was “the most legitimate way to address creditors’ rights.”¹²² The bulk of its reasoning appeared in a footnote:

The absolute-priority rule and plan-voting concept are important tools which legitimize Chapter 11 by protecting creditors, *in reality or by perception*, from unfair treatment by debtors. The Commission believes that these creditor protections, *albeit largely illusory*, are fundamental to the Bankruptcy Code’s careful balance between debtor and creditor rights. Furthermore, the Commission favors maintaining these creditor safeguards to recommending adoption of plan confirmation based on “disposable income” payments, which would likely (i) clog the courts with complex, fact-sensitive litigation about income projections of businesses, and (ii) generate strong opposition in Congress, as did similar legislation proposed as part of the Chapter 10 amendments in 1994.¹²³

It is difficult to imagine how “illusory” protections can, at the same time, be “fundamental” to the balance of debtor-creditor rights. It is also difficult to imagine how a body of creditors that is admittedly apathetic toward the bankruptcy process would become energized in Chapter 12 so as to “clog the courts” with litigation concerning debtors’ income projections. Moreover, no such litigation epidemic has arisen with respect to family farmers in Chapter 12, notwithstanding the inherent difficulty of projecting farm income (which depends, among other things, upon weather conditions over which the farmer has no control). And although Congress might bristle at the suggestion of taking away the creditor vote and absolute priority rule in small business cases, Congress has demonstrated a willingness to dispense with those “fundamental” creditor protections when the circumstances demanded it, as with family farmers and family fishermen. Hopefully, before the plight of small businesses in Chapter 11 reaches a crisis level, Congress will see fit to provide meaningful relief by expanding Chapter 12 to include those who admittedly have had little political clout to protect their own interests.

¹²¹ NAT’L BANKR. REVIEW COMM’N, *supra* note 16, at 617.

¹²² *Id.*

¹²³ *Id.* at 616 n.1573 (emphasis added).

CONCLUSION

Financially distressed small businesses are likely to find it more difficult than ever to reorganize successfully under BAPCPA. BAPCPA imposes a plethora of new burdens on the small business debtor. To achieve a fair, meaningful result for clients, counsel will have to employ innovative, proactive strategies, including pre-filing formation of informal creditors' committees and plan negotiations. The ambiguities and uncertainties created by the new legislation, coupled with the burdens it imposes, demonstrate the need to renew efforts to inform Congress of the economic benefits of small business reorganization, and the need to provide utilitarian avenues for it, including an amended, expanded Chapter 12 procedure. Chapter 12's streamlined process has worked successfully for family farmer reorganizations, maintaining appropriate checks and balances on creditor and debtor interests without imposing unnecessary complication and expense. There is no reason to believe that a Chapter 12-like process could not well serve distressed small businesses and their creditors.