

SMALL BUSINESS PROPOSALS

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Chapter 11 can be a remarkable tool for saving jobs, protecting going-concern values, and producing recoveries for creditors. The Commission supports the continued availability of relief under Chapter 11 for debtors of all types, large and small. As explained more fully below, the Commission recommends reform measures designed to strengthen the 1994 “small business” amendments to reduce the cost and delay in small business Chapter 11 cases.

The evidence collected by the Working Group on Small Business, Partnerships and Single-Asset Real Estate (“Working Group”) suggests that there are two distinct categories of small business Chapter 11 cases. Each requires its own reform measures. The first category consists of the relatively small proportion of cases in which the debtor has a reasonable likelihood of confirming a plan and succeeding as a going business. For this group of cases, the primary goal is to increase the likelihood of successful reorganization and the return to creditors, by reducing the high cost of, and time delays in, Chapter 11. The second category consists of the much larger proportion of cases in which the debtor has no reasonable prospect of rehabilitation.¹⁵⁴⁷ For this group of cases, the primary goal is to reduce the amount of time they consume in Chapter 11.

With respect to the first category, the Commission has identified need for the following reforms: (1) simplification of the disclosure and plan confirmation process;

¹⁵⁴⁷ See, e.g., Letter from J. James Jenkins to the Commission regarding the Small Business Proposal (Apr. 14, 1997).

(2) prompt plan-filing and plan-confirmation deadlines, subject to extension upon proper showing by the debtor; and (3) additional reporting by the debtor regarding postfiling operations and review of that information by the U.S. Trustee or Bankruptcy Administrator.¹⁵⁴⁸

With respect to the second category, those cases in which reorganization is improbable, the Commission has found a need for a longer list of reforms aimed at identifying those cases early and removing them from Chapter 11 via dismissal or conversion to Chapter 7.

In the process of arriving at its recommendations of the Commission reached the following conclusions and arrived at the following findings of fact in arriving at its recommendations to the Commission.

Available statistics (the adequacy of which is found to be poor elsewhere in this report) reveal that only a small fraction of the Chapter 11 cases filed nationwide end in confirmation of a plan of reorganization.¹⁵⁴⁹ The vast majority of cases are dismissed or converted. Furthermore, only a fraction of confirmed plans are fully performed.¹⁵⁵⁰ One study reported that, based on historical data, a debtor entering Chapter 11 only has a 6.5% chance of confirming and performing a plan, *i.e.*,

¹⁵⁴⁸ Hereinafter, "U.S. Trustee" is defined to include Bankruptcy Administrator.

¹⁵⁴⁹ See Edward M. Flynn, Statistical Analysis of Chapter 11, Administrative Office of the United States Courts -- Statistical Analysis & Reports Division (SARD) - Bankruptcy Division 10 (Oct. 1989)(unpublished report) (finding that the confirmation rate for Chapter 11 cases filed between 1979 to 1986 was only 17%); Lynn M. LoPucki, *The Debtor in Full Control--Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 AM. BANKR. L.J. 99, 100 (1983). *But see* Letter from Hon. A. Thomas Small, Bankruptcy Judge, to the National Bankruptcy Review Commission regarding the Small Business Proposal (Feb. 12, 1997) (reporting a 62.9% plan confirmation rate in the Eastern District of North Carolina).

¹⁵⁵⁰ Flynn, *supra* note 1349, at 13 (concluding that only 10 to 12% of the Chapter 11 cases filed ever result in successful reorganization). *Accord* Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 325 (1992)(finding that only 10% of the Chapter 11 cases filed in a particular study area resulted in a consummated plan); Nancy Rhein Baldiga, *Is This Plan Feasible? An Empirical Legal Analysis of Plan Feasibility*, 101 COM. L.J. 115 (1996)(concluding that even in cases in which the Chapter 11 reorganization plan has undergone an extensive feasibility challenge, half of the confirmed, nonliquidating plans failed to fully consummate).

surviving as a rehabilitated entity.¹⁵⁵¹ Another study suggests that the overall success rate for Chapter 11 cases appears lower than under the Bankruptcy Act.¹⁵⁵²

Reasonable people differ about how to define “success” in Chapter 11 cases.¹⁵⁵³ 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.¹⁵⁵⁴

The Commission concluded that the appropriate use of Chapter 11 is one in which the debtor confirms and materially performs a plan of reorganization.¹⁵⁵⁵ The benefits of an orderly liquidation can be realized through a liquidating Chapter 11 plan or a Chapter 7 case. A case which is converted or dismissed after a lengthy, inconclusive protection of the debtor in possession in reliance on the automatic stay should not be considered a success.

¹⁵⁵¹ Jensen-Conklin, *supra* note 1550, at 325.

In light of the facts [sic] that 17% of Chapter 11 cases get confirmed, about one-quarter of these involve liquidating plans, and that some of the reorganizations are not successful, it can be estimated that only about 10 to 12 percent of Chapter 11 cases result in an actual reorganization of the filing entity. Further, some of these reorganizations may not be considered fully successful even if the business is reorganized and the creditors are paid. Some reorganized businesses will falter a second time. This may lead to a second Chapter 11, a liquidation, or the sale of the business.

Flynn, *supra* note 1549, at 13

¹⁵⁵² LoPucki, *supra* note 1549, at 100 (finding in a discrete survey area that cases during the first year following the inauguration of the Bankruptcy Code yielded a confirmation rate of only 26%).

¹⁵⁵³ See, e.g., American Bankruptcy Institute Bankruptcy Reform Study Project, *Defining Success in Business Bankruptcy* (May 6, 1995)(unpublished paper presented at the 1995 Annual Meeting of the American Bankruptcy Institute).

¹⁵⁵⁴ *Id.*

¹⁵⁵⁵ See 11 U.S.C. § 1129(a)(11)(1994)(requiring a judicial determination that confirmation is not likely to be followed by liquidation or further reorganization); 11 U.S.C. § 1112(b)(2), (7) (1994) (providing grounds for the conversion or dismissal of a Chapter 11 case if there is an “inability to effectuate a plan” or an “inability to effect substantial consummation of a confirmed plan”).

According to the many of the experienced individuals who appeared before the Working Group, the primary reason for the low Chapter 11 confirmation rate is that the great majority of Chapter 11 debtors lack any genuine prospect for reorganization, *i.e.* fundamentally, business viability is measured in terms of a consistent generation of cash revenue in excess of cash disbursed does not exist. Debtors are not required to make any showing of viability to file Chapter 11 (and the Commission has not proposed the imposition of such a requirement). At the same time, a moribund business generally has little to lose by seeking relief in bankruptcy. By filing under Chapter 11, the debtor gets the immediate benefit of the automatic stay, retains control of the business, and is under no requirement to pay creditors or file a plan promptly. Chapter 11 thus lures many small business debtors who have no realistic hope of confirming a plan.¹⁵⁵⁶

Far too [frequently], counsel file a Chapter 11 petition for a debtor, the business of which is in such straits and so incapable of recovery that the Chapter 11 case is nothing more than a holding pattern before an inevitable conversion to Chapter 7 or dismissal. Such a case serves no useful purpose and instead merely prolongs a painful process. Clients would be far better served if counsel examined the economic potential of the business before filing a petition to “rehabilitate” a moribund debtor.¹⁵⁵⁷

It is essential to the legitimacy and continued public acceptance of Chapter 11 that its exceptional protections be limited to those cases in which the public derives

¹⁵⁵⁶ “Chapter 11 is more an intensive-care ward (or mortuary) than a healing potion for sick businesses.” Hon. Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 CORNELL L. REV. 1088 (1992).

¹⁵⁵⁷ 5 ASA S. HERZOG & LAWRENCE P. KING, COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 84.02[1][d] (1992). As one bankruptcy judge has remarked in the context of one plan found to be unfeasible:

Bankruptcy is perceived as a haven for wistfulness and the optimist’s Valhalla where the atmosphere is conducive to fantasy and miraculous dreams of the phoenix arising from the ruins. Unfortunately, this Court is not held during the full moon, and while the rays of sunshine sometimes bring the warming rays of the sun, they more often also bring the bright light that makes transparent and evaporates the elaborate financial fantasies constructed of nothing more than the gossamer wings and of sophisticated tax legerdemain.

In re Maxim Indus., Inc., 22 B.R. 611, 613 (Bankr. D. Mass. 1982).

a benefit therefrom.¹⁵⁵⁸ Creditors in an open economy have a legitimate interest in a prompt, fair determination of the viability of Chapter 11 debtors. As explained more fully below, a central feature of the Commission's Recommendation is to identify promptly those cases in which there is no real likelihood of rehabilitation and provide an effective mechanism for dismissing those cases or converting them to Chapter 7.

The length of time a business remains in Chapter 11 is critically important. "During that time, the business is at risk because management incentives are inappropriate, professional fees build up at a rapid rate, and business uncertainties increase."¹⁵⁵⁹ Furthermore, unsecured creditors lose the time value of money while they wait to collect their debt during the pendency of the case. The longer they await distribution, the greater is their loss.¹⁵⁶⁰

Yet studies reveal that Chapter 11 debtor often live under the protection of the Bankruptcy Code for literally years,¹⁵⁶¹ often without providing any meaningful return to unsecured creditors. Indeed, the average time from filing to the confirmation of a plan has been historically estimated by one government analyst to

¹⁵⁵⁸ See, e.g., Letter from J. James Jenkins to the Commission regarding the Small Business Proposal (Apr. 14, 1997) (noting that the current resolution of small business Chapter 11 cases undermines the reputation of the bankruptcy system).

¹⁵⁵⁹ LoPucki, *supra* note 1549. See also Philip J. Hendel, Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities (Dec. 17, 1996) ("Most small business Chapter 11 cases fail. They do, however, take a while to filter through the system. There are usually substantial administrative fees and expenses that have been paid to the professionals. When the well runs dry, the cases therefore die from dehydration. When they are finally converted to Chapter 7 there is rarely a dividend to unsecured creditors).

¹⁵⁶⁰ "Time is money." Since unsecured creditors are not paid pendency interest on their claims, the loss becomes exponentially greater the longer they are forced to await payment. See Hon. A. Thomas Small, 1 AM. BANKR. INST. L. REV. 305 (1993).

¹⁵⁶¹ Cf. Marcy J.K. Tiffany, A Study of Chapter 11 Confirmation Statistics: Central District of California, Los Angeles Division for Cases Filed in 1994 (unpublished study on file with the author and the National Bankruptcy Review Commission)(analyzing 1349 cases filed during 1994 in the Los Angeles Division of the Central District of California in terms of the rate at which cases were converted, dismissed or confirmed as related to their size measured in terms of assets and liabilities as indicated on the petition at the time of filing. The study concludes that (1) The smallest of cases (less than \$500,000 in liabilities or assets) that are not capable of reorganizing move just as quickly through Chapter 11, if not more quickly, than cases with more than \$500,000 in liabilities or assets; (3) There is some indication that cases with less than \$500,000 in liabilities or assets take somewhat longer to confirm plans than cases with more than \$500,000 in assets or liabilities; and that (4) Overall, the data indicate that cases with less than \$500,000 in liabilities or assets are no less successful in Chapter 11 than cases with more than \$500,000 in liabilities or assets).

exceed two years.¹⁵⁶² Nearly two-thirds of the Chapter 11 confirmations occur in the second or third years after filing, with some cases taking more than five years.¹⁵⁶³

Current law may actually work to slow the resolution of small business Chapter 11 cases. It has been persuasively argued that the consolidation of the separate reorganization Chapters under the Bankruptcy Act into a single chapter that imposes a uniform set of rules for all business cases has caused small business cases to be resolved more slowly than under pre-Code law.¹⁵⁶⁴ Chapter 11 contains a number of procedures that were designed for large cases.¹⁵⁶⁵ “When these large-case procedures were applied to ordinary reorganization cases, the dynamics of ordinary cases became more like the dynamics of large cases. Time in Chapter 11 for the two kinds of cases simply converged.”¹⁵⁶⁶

Congress has in recent years recognized that a “one-size-fits-all approach” to business reorganizations fails to adequately address the needs of a system dominated by small business bankruptcies.¹⁵⁶⁷ Commentators have also noted that typical Chapter 11 practice is not well suited to small business cases.

It takes no elaborate empirical study to justify the conclusion that the problems facing a publicly held corporation facing a mass-tort problem, are quite removed from a “mom-pop” corporation running a shoe repair shop Obviously, a case involving a publicly held corporation with varied constituents requires safeguards, and therefore, the process is justifiably slow. The cost of administration, while it is subject to the court’s control, is unavoidably high However, these same safeguards become insurmountable obstacles to

¹⁵⁶² Flynn, *supra* note 1549, at 23-24 (indicating that the median time from filing to confirmation ranged from a low of 461 days to a high of 941 days).

¹⁵⁶³ *Id.*

¹⁵⁶⁴ See Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729 (comparing the results of five empirical studies of the length of reorganization cases resulting in the confirmation of a plan of reorganization). See, e.g., Jeffrey W. Morris, “Letter from Porter, Wright, Morris & Arthur Regarding the Proposals Before the Small Business Working Group” (Dec. 13, 1996) (“There is little dispute that Chapter 11 cases take too long to complete.”).

¹⁵⁶⁵ LoPucki, *supra* note 1364, at 745.

¹⁵⁶⁶ *Id.*

¹⁵⁶⁷ See 11 U.S.C. §§ 101(51C), 1102(a)(3), 1121(e) (1994)(“small business” amendments added to the Code by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106); S. 1985, 102d Cong., 1st Sess. (1991)(failed legislative effort which attempted to create a separate chapter for small business cases).

. . . small corporations, elevating the costs of the system to unacceptable proportions.¹⁵⁶⁸

The Commission's Proposal addresses the need to move small business Chapter 11 cases at a pace appropriate for those cases by (i) establishing presumptive plan-filing and plan-confirmation deadlines specially tailored to fit small business cases; and (ii) directing bankruptcy judges to use modern case-management techniques in all small business cases to further reduce cost and delay.¹⁵⁶⁹

The need for reform can perhaps best be underscored by the fact that nearly every jurist, academician, practitioner, and representative who appearing before the Commission has expressed the unmistakable sentiment that the system needs to be tailored in order to better serve the interests of justice and the special needs of small business debtors and their creditors. Although there were certainly differences in opinion as to the nature and extent of reform that should be made, there has little been more than a handful of advocates for retaining the status quo. To address these concerns, the Commission has undertaken to develop a Proposal which will both expedite the process for debtors that can be saved, and conclude the process quickly for those which cannot benefit from the protections of Chapter 11.

Competing Considerations. Overall, the Commission entertained a wide divergence in views in arriving at its determination. On June 20, 1996, the Working Group held its first public meeting to develop a Proposal to improve the administration of small business Chapter 11 cases. Since this first session, the Working Group met across the country at seven meetings and formulated its Proposals to the Commission. At these numerous gatherings, the Working Group and on some occasions other members of the Commission invited comment, and presented their concerns and ideas to the public. In this process many competing considerations were advanced to the Working Group and to the full Commission. Some of them are addressed in the ensuing paragraphs. Others are addressed below.

A number of able and experienced witnesses expressed strong disagreement with some of the unfavorable views of small business Chapter 11 expressed in this

¹⁵⁶⁸ Hon. Alexander L. Paskay & Frances Pilaro Wolstenholme, *Chapter 11: A Growing Cash Cow: Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331 (1993).

¹⁵⁶⁹ The use of "fast track" procedures in bankruptcy was pioneered in the mid 1980's by the Hon. A. Thomas Small, Chief Bankruptcy Judge for the Eastern District of North Carolina. Judge Small's fast track involves three simple procedures: (i) requiring early filing of the plan; (ii) conditional approval of the disclosure statement; and (iii) a combined hearing on the disclosure statement and plan confirmation. See A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305 (1993). A number of other districts have since similar "fast track" procedures, see, e.g., Pamela J. Griffith, *Fast Track Chapter 11 in the District of Oregon*, 41 FED. BAR NEWS & J. 185 (1994). But see *infra* note 1633 and accompanying text.

Report These spokespersons, while agreeing that some abusive cases are sometimes a problem, pointed out a proud record of a number of courts, U.S. Trustees and Bankruptcy Administrators, particularly in North Carolina, California and Oregon (among others) which have found existing law adequate to address the problem. Techniques such as thoughtful judicial management of cases, increased U.S. Trustee/Bankruptcy Administrator focus on compliance issues early in the case and other case-management approaches were more than adequate to address the problems identified by the efforts of the Working Group, in the view of these witnesses, without some or all of the reforms proposed by the Commission.

These spokespersons have also contended that a number of the specific Proposals made by the Commission, such as the deadlines for plan filing and the shifting of the burden of proof to the debtor to stay in Chapter 11 are too short, too onerous and will deprive too many debtors of a fair opportunity to achieve reorganization in Chapter 11.

In addition, a number of additional points of view were considered and rejected.

First, Prior to promulgation of the 1994 Bankruptcy Reform Act, Congress considered and rejected proposed “Chapter 10” legislation, which would have created a separate chapter for businesses with aggregate, liquidated secured and unsecured debts of less than \$2,500,000.¹⁵⁷⁰ The proposed Chapter 10 generated much controversy on a number of substantive grounds, as well as opposition to adding a new chapter to the Bankruptcy Code.¹⁵⁷¹ Critics argued that creating an additional chapter would add unnecessary complexity to the Bankruptcy Code.¹⁵⁷² Furthermore, the proposed new chapter deviated from the absolute priority rule, and permitted use of a Chapter-13-like concept of disposable income.¹⁵⁷³

¹⁵⁷⁰ Memorandum by George H. Singer, Staff Attorney, regarding to Small Business, Partnership & Single-Asset Working Group regarding Chapter 10 (Aug. 12, 1996).

¹⁵⁷¹ *Id.*

¹⁵⁷² *Id.*

¹⁵⁷³ 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.

The Commission has closely examined the merits of separate chapter status, including exhaustive research and review of testimony.¹⁵⁷⁴ Its determination *not* to recommend creation of a separate chapter reflects its conclusion that modifications to the current, carefully crafted Chapter 11 framework tailored specifically for the smaller business provides the appropriate building blocks to allow for expedited and reduced-cost treatment of creditor-ignored debtors, and increased recoveries to unsecured creditors.

Second, several thoughtful and experienced members of the bankruptcy community have urged the Commission to recommend extending Chapter 12 or 13 eligibility to business debtors. The Commission strongly believes that the requirements for creditor voting make Chapter 11 the most legitimate way to address creditors' rights. Therefore, it decline to recommend to the Commission that the law be changed to provide for the administration of small business debtors in Chapters 12 or 13.¹⁵⁷⁵

Third, the Commission considered and rejected recommending deferral of discharge in all cases until completion of plan payments. The Commission proposes no change in the language of section 1141(d), which allows for deferred discharge; however, it believes that the costs of routinely enforcing the deferred discharge rule would disproportionately impact unsecured creditors, whose recoveries would be diminished by the increased expense of administering the debtor's estate. Also, concerns were expressed that a deferred discharge might make it hard for some debtors to obtain financing during the gap between confirmation and plan consummation.

Fourth, some commentators urged that no debtor should continue in Chapter 11 under any circumstances if it gets behind in its payables. The Commission, however, rejected the notion that the debtor must be current on all administrative expense claims as a condition to continued enjoyment of Chapter 11.

¹⁵⁷⁴ Memorandum from Stephen H. Case, Senior Adviser, & George H. Singer, Staff Attorney, to the Commission regarding Working Group Meeting on Small Business & Single-Asset Real Estate (July 22, 1996).

¹⁵⁷⁵ *E.g.*, Transcript of National Bankruptcy Review Commission Hearing at 40-41 (June 20, 1996) (testimony of former Bankruptcy Judge Ralph H. Kelley from the Eastern District of Tennessee); *see also* Philip J. Hendel, "Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities" (Dec. 17, 1996); Memorandum by Stephen H. Case, Senior Adviser, Jennifer C. Frasier, Staff Attorney, & George H. Singer, Staff Attorney, to Commission regarding Sept. 19, 1996 Meeting of Working Group on 'Small Business' Bankruptcy" (Oct. 8, 1996).

RECOMMENDATIONS

2.5.1 *Defining the term “Small Business”*

A “small business debtor” is any debtor in a case under Chapter 11 (including any group of affiliated debtors) which has aggregate noncontingent, liquidated secured and unsecured debts as of the petition date or order for relief of five million dollars (\$5,000,000)¹⁵⁷⁶ or less and any single asset real estate debtor as defined in 11 U.S.C. § 101(51B), regardless of the amount of such debtor’s liabilities.

2.5.2 *Flexible Rules for Disclosure Statement and Plan*

Give the bankruptcy courts authority, after notice and hearing, to waive the requirements for, or simplify the content of, disclosure statements in small business cases where the benefits to creditors of fulfillment of full compliance with Bankruptcy Code § 1125 are outweighed by cost and lack of meaningful benefit to creditors which would exist if the full requirements of § 1125 were imposed;

The Advisory Committee on Bankruptcy Rules of the Judicial Conference (“Rules Committee”) shall be called upon to adopt, within a reasonable time after enactment, uniform safe-harbor standard forms of disclosure statements and plans of reorganization for small business debtors, after such experimentation on a local level as they deem appropriate. These forms would not preclude parties from using documents drafted by themselves or other forms, but would be propounded as one choice that plan proponents could make, which, if used and completed accurately in all material respects, would be

¹⁵⁷⁶ This dollar figure will be periodically adjusted for inflation pursuant to 11 U.S.C. § 104(a) (1994) which provides as follows:

The Judicial Conference of the United States shall transmit to the Congress and to the President before May 1, 1985, and before May 1 of every sixth year after May 1, 1985, a recommendation for the uniform percentage adjustment of each dollar amount in this title and in section 1930 of title 28.

presumptively deemed upon filing to comply with all applicable requirements of Bankruptcy Code §§ 1123 and 1125. The forms shall be designed to fulfill the most practical balance between (i) on the one hand, the reasonable needs of the courts, the U.S. Trustee, creditors and other parties in interest for reasonably complete information to arrive at an informed decision and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors; and

Repeal those provisions of 11 U.S.C. § 105(d) which are inconsistent with the proposals made herein, *e.g.*, those setting deadlines for filing plans.

Amend the Bankruptcy Code to expressly provide for combining approval of the disclosure statement with the hearing on confirmation of the plan.

2.5.3 *Reporting Requirements*

To create uniform national reporting requirements to permit U.S. Trustees, as well as creditors and the courts, better to monitor the activities of Chapter 11 debtors, the Rules Committee shall be called upon to adopt, with a reasonable time after enactment, amended rules requiring small business debtors to comply with the obligations imposed thereunder. The new rules will require debtors to file periodic financial and other reports, such as monthly operating reports, designed to embody, upon the basis of accounting and other reporting conventions to be determined by the Rules Committee, the best practical balance between (i) on the one hand, the reasonable needs of the court, the U.S. Trustee, and creditors for reasonably complete information and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors. Specifically, the Rules Committee, shall be called upon to prescribe uniform reporting as to:

- a. the debtor's profitability, *i.e.*, approximately how much money the debtor has been earning or losing during current and relevant recent fiscal periods;
- b. what the reasonably approximate ranges of projected cash receipts and cash disbursements (including those required by law or contract and those that are discretionary but excluding prepetition debt not lawfully payable after the entry of order for relief) for the debtor appear likely to be over a reasonable period in the future;

- c. how approximate actual cash receipts and disbursements compare with results from prior reports;**
- d. whether the debtor is or is not (i) in compliance in all material respects with postpetition requirements imposed by the Bankruptcy Code and the Bankruptcy Rules and (ii) filing tax returns and paying taxes and other administrative claims as required by applicable nonbankruptcy law as will be required by the amended statute and rules and, if not, what the failures are, how and when the debtor intends to remedy such failures and what the estimated costs thereof are; and**
- e. such other matters applicable to small business debtors as may be called for in the best interests of debtors and creditors and the public interest in fair and efficient procedures under Chapter 11.**

2.5.4 *Duties of the Debtor in Possession*

The debtor is required to:

- a. append to the voluntary petition or, in an involuntary case, to file within three days after the order for relief, either (A)(i) its most recent balance sheet, statement of operations and cash-flow statement and (ii) its most recent federal income tax return or (B) a statement made under penalty of perjury that no such financial statements have been prepared or that no federal income tax return has been filed or (C) both;**
- b. attend meetings, at which the debtor is represented by its senior management personnel and counsel, scheduled by the court, the U.S. Trustee, or the Bankruptcy Administrator including, but not limited to initial debtor interviews, court-ordered scheduling conferences, and meetings of creditors convened under 11 U.S.C. § 341;**
- c. file all schedules and statements of financial affairs for small business debtors within the limits set by the Bankruptcy Rules, unless the court, upon notice to the U.S. Trustee and a hearing, grants an extension, which extension or extensions shall not, in any event, exceed thirty (30) days after the order for relief absent extraordinary and compelling circumstances;**

- d. comply with postpetition obligations, including but not limited to the duties to: file tax returns, maintain appropriate and reasonable current insurance as is customary and appropriate to the industry, and timely pay all administrative expense tax claims, except those being contested by appropriate proceedings being diligently prosecuted;**
- e. create within ten (10) business days of the entry of order for relief (or as soon thereafter as possible in case all banks contacted during the first ten (10) business days decline the business) separate deposit accounts with a bank or banks in which the debtor shall be required to timely deposit, until a plan is confirmed or the case is dismissed or converted or a trustee is appointed, after receipt, all taxes collected or withheld by it for governmental units. In compelling circumstances, the court may dispense with these requirements after notice and a hearing;**
- f. allow the U.S. Trustee or its designated representative to inspect the debtor's business premises, books and records at reasonable times on reasonable prior written notice to the debtor.**

2.5.5 *Deadlines for Plan Filing and Confirmation*

In small business cases only, require that the disclosure statement, if any, and plan must be filed within 90 days after the entry of order for relief, unless extended as permitted below. During this 90-day period, only the debtor may file a plan unless on request of a party in interest made during this period and after notice and a hearing, the court, for cause, orders otherwise. In small business cases only, require the plan to be confirmed within 150 days after the entry of order for relief, unless extended as permitted below.

2.5.6 *Burden of Proof for Extensions of Deadlines*

Permit extensions of the deadlines for filing and approving disclosure statements, if any, and filing and confirming plans of reorganization only if the debtor, having duly noticed and appeared at the necessary extension hearing conducted and ruled upon prior to the expiration of the deadline, if any, and having carried the burdens of coming forward and persuasion, demonstrates by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time. No such deadline may be extended unless a new deadline is imposed at the time the extension is granted. The Bankruptcy and Judicial Codes will require the U.S. Trustee, as the case

may be, to be a recipient of notice of extension hearings and to participate actively therein, in order to assure, to the maximum extent feasible, that the interests of the public are protected when determinations are made as to whether small business debtors receive extensions and have proven by a preponderance of the evidence that it is more likely than not that they will confirm a plan within a reasonable time.

2.5.7 *Scheduling Conferences*

Require the bankruptcy court to promptly conduct at least one on-the-record scheduling hearing, on notice to the U.S. Trustee and the debtor's 20 largest unsecured creditors to be sure that the deadlines discussed above are met except that no such hearing is required if an agreed order is filed by the debtor and U.S. Trustee and approved by the court after notice and hearing. The court shall also conduct such other scheduling hearings and status conferences as it deems fit and proper. Whenever possible, these hearings shall be scheduled in conjunction with other mandatory events so as to minimize to the most reasonable practicable extent, the time of debtor personnel spent in court and at official meetings.

2.5.8 *Serial Filer Provisions*

Provide in the Bankruptcy Code that, with respect to any debtor (or any entity which has succeeded to substantially all the debtor's assets or business) which files a second case while another case is pending in which such debtor is the (or one of the) debtor(s) or in the event that it again becomes a debtor in a Chapter 11 case within two years after an order of dismissal of a Chapter 11 case in which it was the debtor has become a final order or a Chapter 11 plan has been confirmed, shall not be entitled to the section 362(a) stay unless, after it has become a debtor, it bears the burdens of coming forward and of persuasion, by a preponderance of the evidence, that (1) the new case has resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and (2) it is more likely than not that it will confirm a feasible plan, but not a liquidating plan, within a reasonable time. In cases involving such debtors when the owners have transferred the business to a new legal entity, owned and arranged by them, the section 362(a) stay would apply on filing but would be lifted on a verified, *ex parte* motion of the U.S. Trustee, with the right to have it reimposed upon a showing of (1) and (2) above. The Federal Rule of

Civil Procedure governing injunctions applies to the court's award of a stay to the debtor.

2.5.9 *Expanded Grounds for Dismissal or Conversion and Appointment of Trustee*

a. Modify section 1112 to read as follows:

- (b)(1) Except as provided in subsection (c) of this section or in section 1104(a)(3) of this title, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court shall convert a case under this chapter to a case under Chapter 7 of this title or shall dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, where movant establishes cause, except that such relief shall not be granted if the debtor or another party in interest objects and establishes both:
- (A) that it is more likely than not that a plan will be confirmed within a time as fixed by this title or by order of the court; and
 - (B) if the cause is an act or omission of the debtor:
 - (i) that there exists a reasonable justification for the act or omission; and
 - (ii) that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion unless the movant expressly consents to a continuance for a specific period of time or there are compelling circumstances beyond the control of the debtor which justify an extension.
- (2) For purposes of this subsection, cause includes:
- (A) substantial or continuing loss to or diminution of the estate;
 - (B) gross mismanagement of the estate;
 - (C) failure to maintain appropriate insurance;
 - (D) unauthorized use of cash collateral harmful to one or more creditors;
 - (E) failure to comply with an order of the court;
 - (F) failure timely to satisfy any filing or reporting requirement established by this title or by applicable rule;
 - (G) failure to attend the section 341(a) meeting of creditors or an examination ordered under Bankruptcy Rule 2004;

- (H) failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee or;
 - (I) failure timely to pay taxes due after the order for relief or to file tax returns due after the order for relief;
 - (J) failure to file or confirm a plan within the time fixed by this title or by order of the court; and
 - (K) failure to pay any fees or charges required under Chapter 123 of title 28.
- (3) The court shall commence the hearing on any motion under this subsection within 30 days after filing of the motion, and shall decide the motion within 15 days after commencement of the hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

b. Additional Grounds for Appointment of Trustee

Add the following new section to 11 U.S.C. § 1104:

- (a)(3) where grounds exist to convert or dismiss the case under section 1112 of this title, but the court determines that the appointment of a Chapter 11 trustee is in the best interests of creditors and the estate.

2.5.10 *Enhanced Powers of the United States Trustee and Bankruptcy Administrator*

Add a new subclause (e) to 11 U.S.C. § 341, and amend 28 U.S.C. § 586 (the general statute governing the powers and duties of the U.S. Trustee) and the Manual for Bankruptcy Administrators,¹⁵⁷⁷ (governing the duties of Bankruptcy Administrators) to require U.S. Trustees in every small business debtor case (except where they, in their reasonable discretion determine that the conduct enumerated below is not advisable in the circumstances):

¹⁵⁷⁷ Section 302(d)(3)(I) of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554, 100 Stat. 3119, 3123, provides the statutory authority for the Judicial Conference of the United States to establish the bankruptcy administrator program.

(1)(a) to conduct an initial debtor interview (“IDI”) with the debtor as soon as practicable after the entry of order for relief but prior to the first meeting scheduled under Bankruptcy Code § 341(a). At the IDI, the U.S. Trustee shall, at a minimum, begin to investigate the debtor’s viability, inquire about the debtor’s business plan, explain the debtor’s obligations to file monthly operating reports and other required reports, attempt to develop an agreed scheduling order, and inform the debtor of other Chapter 11 obligations;

(b) when determined by the U.S. Trustee to be appropriate and advisable, to visit the appropriate business premises of the debtor and ascertain the general state of the debtor’s books and records and verify that the debtor has filed its tax returns. This visit should take place in connection with or reasonably promptly after the IDI (wherever possible, these events shall be combined with other events so as to minimize to the most reasonable practicable extent the amount of time of debtor personnel spent in court and at official meetings); and

(c) to review and monitor diligently on a continuous basis each debtor’s activities, with a view to identifying as promptly as possible those debtors which do not pass the test of being more likely than not to be able to confirm a Chapter 11 plan within a reasonable time; and

(2) in cases where, upon the basis of continuing review, monitoring or otherwise, the U.S. Trustee finds material grounds for any relief under Bankruptcy Code § 1112, to move the court promptly for relief.

DISCUSSION

2.5.1 *Defining the term “Small Business”*

A “small business debtor” is any debtor in a case under Chapter 11 (including any group of affiliated debtors) which has aggregate noncontingent, liquidated secured and unsecured debts as of the petition date or order for relief of five million dollars (\$5,000,000)¹⁵⁷⁸ or less and any single asset real estate debtor as defined in 11 U.S.C. § 101(51B), regardless of the amount of such debtor’s liabilities.

Comments. The concept of a “small business” is a fluid one. To a large extent, crafting a definition requires consideration of the context in which the definition will be applied. Selecting a definition of small business for purposes of bankruptcy requires a series of trade-offs between accuracy and precision, in light of the availability and quality of information available to classify the small business debtor at the outset of a bankruptcy case.

Under current bankruptcy law, a “small business” is defined as:

a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed \$2,000,000.¹⁵⁷⁹

¹⁵⁷⁸ This dollar figure will be periodically adjusted for inflation pursuant to 11 U.S.C. § 104(a) which provides as follows:

The Judicial Conference of the United States shall transmit to the Congress and to the President before May 1, 1985, and before May 1 of every sixth year after May 1, 1985, a recommendation for the uniform percentage adjustment of each dollar amount in this title and in section 1930 of title 28.

¹⁵⁷⁹ 11 U.S.C. § 101(51C) (1994).

The Small Business Administration (“SBA”),¹⁵⁸⁰ by contrast, defines a “small business concern”¹⁵⁸¹ as “one which is independently owned and operated and which is not dominant in its field of operation.”¹⁵⁸² Other relevant factors to the SBA’s definition of an entity as a small business concern include the number of employees, dollar volume of the business, net worth, net income, a combination thereof, or “other appropriate factors.”¹⁵⁸³ In a typical case, the SBA judges the size of a business by number of employees or annual receipts.¹⁵⁸⁴ Similar to this definition, Senate Bill 1985 would have defined small business by reference to a number of factors including the number of employees and creditors, the value of the debtor’s assets, the dollar

¹⁵⁸⁰ The Small Business Administration is a nonincorporated, federal agency created to aid, counsel, and financially assist small-business concerns so that free competitive enterprise is preserved for small, private businesses. *See* 15 U.S.C. § 631(a) (1994).

¹⁵⁸¹ 15 U.S.C. § 632(a) (Supp. 1996). *See* George H. Singer, “Small Business & Single-Asset Working Group: Chapter 10” (Aug. 12, 1996)(memorandum on file with the National Bankruptcy Review Commission).

¹⁵⁸² *Id.*

¹⁵⁸³ *Id.* § 632(a)(2)(A), (B) (Supp. 1996).

¹⁵⁸⁴ George H. Singer, “Small Business & Single-Asset Working Group: Chapter 10” (Aug. 12, 1996)(memorandum on file with the National Bankruptcy Review Commission) (citing telephone conversation with John Haitzuka, Attorney, Office of the Small Business Administration, Washington, D.C. (August 13, 1996); Business Credit & Assistance, 13 C.F.R. § 121.201 (March 1, 1996)). The SBA calculates annual receipts as follows:

(1) *Receipts* means “total income” (or in the case of a sole proprietorship “gross income”) plus the “costs of goods sold” as these terms are defined or reported on Internal Revenue Service (IRS) Federal tax return forms (Form 1120 for corporations; Form 1120S for SubChapter S corporations; Form 1065 for partnerships; and Form 1040, Schedule F for farm or Schedule C for other sole proprietorships). However, the term receipts excludes net capital gains or losses, taxes collected for and remitted to a taxing authority if included in gross or total income, proceeds from the transactions between a concern and its domestic or foreign affiliates (if also excluded from gross or total income on a consolidated return filed with the IRS), and amount collected for another by a travel agent, real estate agent, advertising agent, or conference management service provider.

(2) *Complete fiscal year* means a taxable year including any short period. Taxable year and short period have the meaning attributed to them by the IRS.

(3) Unless otherwise defined . . . all terms shall have the meaning attributed to them by the IRS . . .

Business Credit & Assistance, 13 C.F.R. § 121.104 (March 1, 1996).

volume of the debtor's sales, the nature and substance of the debtor's business, and others.¹⁵⁸⁵

Although a searching inquiry by the court under a multifaceted definition might define small business in a precise manner, it is also likely to engender litigation at the outset of a Chapter 11 case, during which time a debtor is preoccupied with preparing schedules, obtaining cash collateral orders, and the like. By contrast, a bright-line definition minimizes litigation and enables the court and counsel to focus on the merits of the Chapter 11 case.

Developing a bright line in the context of bankruptcy is a difficult task. Very often, little financial information even approaching public-company quality is available upon the commencement of a bankruptcy proceeding,¹⁵⁸⁶ although more detailed information is available within fifteen days postpetition.¹⁵⁸⁷ Specifically, under current laws, the voluntary debtor must file, *inter alia*, a petition,¹⁵⁸⁸ a Summary of

¹⁵⁸⁵ S. 1985 proposed to add the following definition to § 101 of title 11:

- (54) "small business" means a person engaged in commercial and business activities where, if appropriate, after court determination, it is found that the best interests of an estate will be served by having such person deemed to be a small business, in light of --
- (A) the number of employees of the person's business activity;
 - (B) the number of creditors of the person's activity;
 - (C) the number of secured, priority, and unsecured creditors of the person's business activity;
 - (D) the value of the assets of the person's business activity;
 - (E) the dollar volume of sales of the person's business activity;
 - (F) the nature and substance of the person's business activity;
 - (G) the history of the person's business activity;
 - (H) the nature and substance of the person's business activity as measure by similar persons engage in the same business activity; and
 - (I) other pertinent factors.

¹⁵⁸⁶ The only financial information required as of the petition date are summary statistics on the debtor's assets, liabilities, creditors and employees. This information is reported in categories, such as "less than \$50,000" or "greater than \$100,000,000." *See* Official Form 1 of the Bankruptcy Code.

¹⁵⁸⁷ FED. R. BANKR. P. 1007(c); Official Forms 6 & 7 of the United States Bankruptcy Code. The court may grant an extension of time for the filing of a debtor's schedules and statements on motion for cause shown. *Id.* Anecdotal reports to the Working Group suggest that such extensions are routinely granted.

¹⁵⁸⁸ OFFICIAL FORM 1 of the United States Bankruptcy Code.

Schedules,¹⁵⁸⁹ Schedules of Assets and Liabilities,¹⁵⁹⁰ and “gross amount of income” received from business operations for the beginning of the calendar year preceding the date on which the case was filed and the two years immediately preceding this calendar year.¹⁵⁹¹

The forms on which these financial data are filed must follow the Official Forms prescribed by the Judicial Conference of the United States.¹⁵⁹² Existing forms draw out much balance-sheet information, reflecting a historical background based on asset liquidation rather than capitalization of income. Schedules A & B require the debtor to list all real and personal property owned by the debtor.¹⁵⁹³ Schedules D, E & F require the debtor to list each secured, unsecured priority, and unsecured nonpriority claim against the debtor.¹⁵⁹⁴ However, less detailed information is available about the debtor’s income. Questions 1 & 2 of the Statement of Financial Affairs requires the debtor to “[s]tate the gross amount of income the debtor has received” from the beginning of the prepetition calendar year to the date of the petition, and from the two years immediately preceding the calendar year.¹⁵⁹⁵ Data on a debtor’s monthly and historical gross and net revenues are not available on a going-forward basis, until six to eight weeks into the case, when the debtor files its first monthly operating report as required by the U.S. Trustee.

The information reported by debtors on their schedules and statements has been criticized as routinely inaccurate or missing, despite the requirement that debtors provide it.¹⁵⁹⁶ This problem appears to be endemic to the nature of bankruptcy, which is generally filed by those in financial distress. Regardless of a debtor’s best

¹⁵⁸⁹ OFFICIAL FORM 6 of the United States Bankruptcy Code.

¹⁵⁹⁰ *See id.*, Schedule A (Real Property), Schedule B (Personal Property), Schedule D (Creditors Holding Secured Claims), Schedule E (Creditors Holding Unsecured Priority Claims), and Schedule F (Creditors Holding Unsecured Nonpriority Claims).

¹⁵⁹¹ OFFICIAL FORM 7 of the United States Bankruptcy Code (question numbers 1 & 2).

¹⁵⁹² FED. R. BANKR. P. 9009.

¹⁵⁹³ *See* Official Form 6 of the United States Bankruptcy Code.

¹⁵⁹⁴ *Id.*

¹⁵⁹⁵ *See* Official Form 7. It is unclear whether the debtor should provide information on its gross income as defined by the Internal Revenue Code, on its net income, or on its gross or net revenues.

¹⁵⁹⁶ *See* Lisa H. Fenning & Craig A. Hart, *Measuring Chapter 11: The Real World of 500 Cases*, 4 AM. BANKR. INST. L. REV. 119 (1996); *see also* Jennifer C. Frasier, *Caught in a Cycle of Neglect: The Accuracy of Bankruptcy Statistics*, 101 COM. L.J. 307 (1996).

intentions and willingness to disclose accurate financial information to the court, the debtor may not have such information if it has not kept good books and records or regularly filed its tax returns. Smaller debtors may not be able to afford a bookkeeper or accountant to maintain proper financial records, and may not have the expertise or time to perform this work themselves. As between information on liabilities and information on revenues, however, the business in financial trouble is more likely to have information on its liabilities, as this is the where the debtor's focus is most likely to be directed.¹⁵⁹⁷ This conclusion comports with testimony of a number of people appearing before the Working Group, who have reported that the nature and size of the debtor's liabilities is the single best predictor of case complexity.¹⁵⁹⁸ For these reasons, the Commission has concluded that a bright-line, liabilities-based test is the most cost-effective manner to accurately categorize a business as large or small for Chapter 11 purposes.

The current bankruptcy-law definition of small business sets the eligibility limit at \$2,000,000 in aggregate, noncontingent, liquidated secured debts.¹⁵⁹⁹ Based on available liabilities data from two of the ninety-four total bankruptcy districts, a liabilities-based definition of \$2,000,000 or less would capture approximately 72% of all Chapter 11 cases filed. Tables which detail this finding and break down liabilities and "gross amount of income" by million dollar categories are provided below:

¹⁵⁹⁷ See, e.g., William T. Neary, *Letter to Linda Stanley re Chapter 11 Statistics for the National Bankruptcy Review Commission* (June 3, 1997) ("[L]ike you, I found the gross income figure both difficult to compile and of questionable validity. In 17 cases, were unable to obtain any information regarding gross income--either the SFA [Statement of Financial Affairs] wasn't filed, or question #1 wasn't answered. . . In another 14 cases, the debtor reported negative gross income figures. ([T])his is an accounting impossibility.) I'm quite sure that a number of debtors are reporting gross revenues or adjusted gross income or some other figure in response to question #1.").

¹⁵⁹⁸ See *id.* at 2 ("My experience has been that it is the size of the debts owed to individual creditors, rather than the level of the debtor's gross income, that determines the level of creditor interest in a case"); see also Elizabeth L. Perris, "Letter to John Gose Regarding the Chapter 11 Special Track" (Feb. 18, 1997) ("It is usually debt structure rather than income that creates complexity in Chapter 11.").

¹⁵⁹⁹ 11 U.S.C. § 101(51C) (1994).

Liabilities on petition date	% of Chapter 11 "small business" debtors						
	<u>M.D. Ala.</u> ¹⁶⁰⁰	<u>S.F/Santa Rosa</u>	<u>Del.</u> ¹⁶⁰¹	<u>Phila.</u>	<u>Chicago</u>	<u>Dallas</u>	<u>Average</u> ¹⁶⁰²
\$10,000,000	100%	94%	16%	92%	96%	82%	93% ¹⁶⁰³
\$5,000,000	93%	92%	15%	87%	88%	72%	86%
\$4,000,000	93%	89%	14%	85%	85%	71%	85%
\$3,000,000	93%	86%	13%	80%	80%	65%	81%
\$2,000,000	83%	74%	13%	73%	73%	59%	72%
\$1,000,000	70%	53%	13%	65%	65%	49%	60%

¹⁶⁰⁰ The data from the Middle District of Alabama and the Northern District of California represent Chapter 11 cases filed in 1995. See Dwight H. Williams, Jr., *Letter to Jennifer C. Frasier Regarding Small Business Chapter 11 Data* (Dec. 5, 1996)(on file with the National Bankruptcy Review Commission); Linda E. Stanley, *Letter to Jennifer C. Frasier Regarding Chapter 11 Data* (Nov. 14, 1996)(on file with the National Bankruptcy Review Commission)..

¹⁶⁰¹ The data from the remaining districts represent open Chapter 11 cases filed between October 1, 1996 and April 30, 1997. See Linda E. Stanley, *Letter to Jennifer C. Frasier Regarding Statistics for Open Chapter 11 Cases filed between 10/01/96 and 04/30/97*" (June 5, 1997)(on file with the National Bankruptcy Review Commission).

¹⁶⁰² This average excludes Delaware cases as this district appears to be anomalous.

¹⁶⁰³ See Jennifer C. Frasier, *Caught in a Cycle of Neglect: The Accuracy of Bankruptcy Statistics*, 101 COM. L.J. (1996) (Empirical study which examines a random sample of 454 Chapter 7, 11, and 13 bankruptcy cases filed during the first and second quarters of 1994 in the following districts: (i) Connecticut; (ii) Louisiana, Eastern District; (iii) Massachusetts; (iv) New Hampshire; (v) New Jersey; (vi) New York, Southern District; and (vii) Texas, Northern District. The author found that debtors filed their schedules of liabilities (schedules D-F) in 369 out of 454 cases. Of these 369 cases (which include Chapters 7, 11, and 13 filings) there were a total of seven cases in which the debtor's aggregate, noncontingent, liquidated secured and unsecured debts, as reported on the schedules, totaled \$10,000,000 or more. As the study's data are not broken down by both size and chapter, it is unclear whether or not these seven cases are all Chapter 11 cases. Assuming, however, that all seven cases were filed under Chapter 11, then approximately 5% (7/137) of all Chapter 11 debtors have liabilities of \$10,000,000 or more).

“Gross amount of income” on petition date	Percentage of Chapter 11 “small business” debtors¹⁶⁰⁴					
	<u>S.F/Santa Rosa</u>	<u>Del.</u>	<u>Phila.</u>	<u>Chicago</u>	<u>Dallas</u>	<u>Average¹⁶⁰⁵</u>
10,000,000	98%	76%	99%	95%	92%	96%
5,000,000	97%	67%	96%	91%	87%	93%
4,000,000	95%	67%	96%	88%	85%	91%
3,000,000	94%	65%	96%	83%	82%	89%
2,000,000	91%	62%	91%	79%	77%	85%
1,000,000	78%	58%	76%	71%	65%	73%

Although these data represent only a small percentage of all bankruptcy districts, and may not be generalizable to the population of Chapter 11 debtors, it would appear that defining small business as one with five million dollars in debt would capture somewhere in the neighborhood of 85% of all Chapter 11 cases.

Competing Considerations. The principal competing consideration argued to the Commission in the process of formulating the definition of small business is that the debt threshold is too high and captures too many cases. This may have the most common and forcefully asserted objection to the Recommendation. The adoption of the Proposal, however, reflects the Commission’s conclusion that the available data indicate that creditor participation at the level of debt selected so often tends to be absent that imposition of the higher standards for small business cases is necessary.

A mandatory liabilities-based test which calculates debts based on the filer’s noncontingent liquidated aggregate debts has several potential drawbacks. First, small

¹⁶⁰⁴ It is unclear whether these data reflect a high percentage of debtors with low income levels or the high percentage of cases in which income information is missing from the debtor’s schedules and statements. It is also unclear whether these data are meaningful given the ambiguity concerning the definition of “gross amount of income” in the Statement of Financial Affairs. *See supra* notes 1595-1597 and accompanying text.

¹⁶⁰⁵ This average excludes Delaware cases as this district appears to be anomalous.

business debtors may have an incentive to “game the system” by reporting their debts as contingent or unliquidated in order to avoid small business treatment. Second, it is arguable that Chapter 11 independently creates strategic incentives for debtors to understate their liabilities and overstate their assets on the face sheet in order to obtain postpetition financing.¹⁶⁰⁶ These potential problems would appear to be either illusory or endemic to the nature of bankruptcy for several reasons. First, the debtor is obliged under penalty of perjury to accurately report information on its schedules and statements.¹⁶⁰⁷ In addition, as noted above, accurate information is difficult to obtain at the outset of any bankruptcy proceeding despite a debtor’s best intentions to accurately report its financial history.

Also, the Working Group ultimately considered and rejected recommending to the Commission that the definition of a small business debtor be couched in alternative terms.¹⁶⁰⁸ The primary competing definition considered by the Working Group was one based on “gross income” as defined by the Internal Revenue Code. Such definition, the Working Group concluded, possessed several distinct advantages over any other. First, a bright-line definition would minimize judicial discretion and litigation over which debtors are subject to “separate-track” treatment, since gross income is a reliable figure, verifiable against a debtor’s tax return. Second, the definition would have the salutary effect of encouraging businesses to file their tax returns, as non-filers would be automatically subject to special-track treatment.

A number of people appearing before the Commission criticized a definition based on gross income, arguing that it (a) would sweep in too many debtors,¹⁶⁰⁹ (b) was an inaccurate indicator of case complexity,¹⁶¹⁰ or (c) was a poor predictor of

¹⁶⁰⁶ At least one empirical study has found that Chapter 11 debtors systematically underreport their liabilities on the face sheet of the bankruptcy petition. Jennifer C. Frasier, *Caught in a Cycle of Neglect: The Accuracy of Bankruptcy Statistics*, 101 COM. L.J. 307, 333-34 (1996) (Finding that liabilities are erroneously reported in Chapter 11 and 13 cases twice as often as in Chapter 7 filings.).

¹⁶⁰⁷ See OFFICIAL FORM 6 of the United States Bankruptcy Code; see also FED. R. BANKR. P. 9011.

¹⁶⁰⁸ George H. Singer, “Discussion Summary, June 20, 1996 Working Group Meeting on ‘Small Business’ Bankruptcy” (July 1, 1996) (unpublished memorandum on file with the National Bankruptcy Review Commission).

¹⁶⁰⁹ E.g., Philip J. Hendel, “Letter Regarding the Small Business Reorganization Proposal” (Jan. 24, 1997) (setting forth the position of the ABI Small Business Subcommittee of the Business Reorganization Committee). The author notes that the Working Group’s gross income test is too liberal. “Experience shows that gross income has little relation to the complexity of a case.” *Id.*

¹⁶¹⁰ E.g., Kenneth Klee, “Electronic Mail Message Regarding the Small Business Working Group’s Proposed Reform” (Oct. 29, 1996) (arguing that a gross revenue test “[w]ill snag several

creditor participation in bankruptcy cases.¹⁶¹¹ Under a gross income definition, for example, General Motors Corporation could fall under the “small business” rules if it suffered anemic sales combined with a high cost of goods sold.

A similar, but alternative definition considered by the Working Group was a gross revenue test based on the debtor’s income tax return. This definition, the Working Group reasoned, had comparable advantages to a straightforward gross-income test, but would not inadvertently capture large businesses, start-up and high tech corporations, research and development companies, and the like. The Working Group has rejected a gross revenue test, however, in favor of a debt-based definition, similar to the current Bankruptcy Code definition of “small business,”¹⁶¹² but set at a higher amount of \$10 million or less.¹⁶¹³

Other definitions considered but rejected by the Working Group include: (i) number of employees, which was rejected out of fear that it would be manipulated pre-petition in order to escape the new separate-track requirements and (ii) number of creditors, which was rejected because no satisfactory bright-line could be crafted.

The Commission recommends that choice of treatment as a “small business” debtor under the Bankruptcy Code should not be optional. If as a policy matter, Congress decides that small business debtors merit special treatment under the Bankruptcy Code, all debtors who meet the definition of “small business” should be subject to the same special track. Otherwise, the separate track will not likely be used. Few debtors will elect to expedite their Chapter 11 cases or submit to greater supervision by the court and U.S. Trustee. The unpopularity of the 1994 amendments

large illiquid businesses . . . Many businesses operate through borrowings and trade credit that leave them with virtually no gross revenues for years. Examples include large land developers and research and development start up companies”).

¹⁶¹¹ See, e.g., Terrance L. Stinnett, “Letter from Goldberg, Stinnett, Meyers & Davis Regarding the Small Business Working Group Proposals” (Nov. 22, 1996); see also Gary White, “Letter to Chairman Williamson from the National Association of Credit Management” (Dec. 2, 1996)(“The \$10 million income test proffered by the Commission would qualify over 91% of all business bankruptcy filings as small businesses.”).

¹⁶¹² 11 U.S.C. § 101(51C) defines a “small business” as:

[A] person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed \$2,000,000.

¹⁶¹³ This higher dollar figure was decided upon to ensure that the definition captures a high percentage of debtors.

to the Bankruptcy Code concerning “small business” debtors, which have been largely ignored¹⁶¹⁴, confirms this hypothesis. Moreover, the mandatory nature of the separate-track treatment minimizes judicial discretion in determining “fast track” eligibility, thereby avoiding litigation.¹⁶¹⁵

2.5.2 Flexible Rules for Disclosure Statement and Plan

Give the bankruptcy courts authority, after notice and hearing, to waive the requirements for, or simplify the content of, disclosure statements in small business cases where the benefits to creditors of fulfillment of full compliance with Bankruptcy Code § 1125 are outweighed by cost and lack of meaningful benefit to creditors which would exist if the full requirements of § 1125 were imposed;

The Advisory Committee on Bankruptcy Rules of the Judicial Conference (“Rules Committee”) shall be called upon to adopt, within a reasonable time after enactment, uniform safe-harbor standard forms of disclosure statements and plans of reorganization for small business debtors, after such experimentation on a local level as they deem appropriate. These forms would not preclude parties from using documents drafted by themselves or other forms, but would be propounded as one choice that plan proponents could make, which, if used and completed accurately in all material respects, would be presumptively deemed upon filing to comply with all applicable requirements of Bankruptcy Code §§ 1123 and 1125. The forms shall be designed to fulfill the most practical balance between (i) on the one hand, the reasonable needs of the courts, the U.S. Trustee, creditors and other parties in interest for reasonably complete information to arrive at an informed decision and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors; and

Repeal those provisions of 11 U.S.C. § 105(d) which are inconsistent with the proposals made herein, e.g., those setting deadlines for filing plans.

¹⁶¹⁴ See Philip J. Hendel, “Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities” (December 17, 1996)(“[The new statutory scheme relating to small business is not mandatory. These provisions have been all but ignored by counsel for debtors, primarily because the period of time provided for exclusivity and filing of plans are constricted when compared to Chapter 11 treatment”).

¹⁶¹⁵ Stephen H. Case & Jennifer C. Frasier, “Discussion Summary, October 18, 1996, Plenary Session on ‘Small Business Bankruptcy Act’ (Oct. 31, 1996)(unpublished memorandum on file with the National Bankruptcy Review Commission).

Amend the Bankruptcy Code to expressly provide for combining approval of the disclosure statement with the hearing on confirmation of the plan.

Comments. One of the central features of Chapter 11, and a major achievement of the Bankruptcy Reform Act of 1978, is the great flexibility it permits in fashioning a plan of reorganization. A plan may include virtually anything upon which the debtor and its creditors agree. A second central feature of Chapter 11 is its strong disclosure requirements. In soliciting acceptances of a plan, the plan proponent must provide creditors and equity holders all information a typical investor would require to cast an informed vote regarding the plan. In exchange for this securities-law-type disclosure, the plan proponent gets broad protection from suits brought under the securities laws.

These disclosure concepts lead to three aspects of Chapter 11 practice that increase cost and delay. In each Chapter 11 case, the debtor's counsel typically drafts the plan of reorganization and a long, prospectus-type disclosure statement from scratch. In most cases, the court conducts a hearing regarding the adequacy of disclosure before the plan is submitted to creditors.¹⁶¹⁶ The disclosure hearing often results in litigation that frequently has more to do with final bargaining about the contents of the plan than the adequacy of disclosure.

The complexity detailed above may be appropriate in large cases. The large debtor's financial and operational problems are generally complex, requiring a specially tailored plan of reorganization. Detailed disclosure is appropriate. Moreover, the transaction costs of disclosure, although high in absolute terms, are usually a small percentage of the large amount of debt, income, and assets at stake in large Chapter 11 cases.

In small Chapter 11 cases, however, the drafted-from-scratch plan, the prospectus-type disclosure statement, and the separate disclosure hearing are more of a costly burden than an aid for cost-effective reorganization.¹⁶¹⁷ The small Chapter

¹⁶¹⁶ Under current law relating to small business debtors, the disclosure hearing and confirmation hearing can be combined in cases involving small business debtors in which the debtor elects to be treated as a small business. 11 U.S.C. § 105(d) (1994). Very few such debtors so elect, probably because the election shortens the debtor's plan exclusivity period and requires the debtor to file a plan within 160 days of filing the petition. *See* 11 U.S.C. § 1121(e), 1125(f) (1994).

¹⁶¹⁷ *See, e.g.,* The Honorable Robert D. Martin, "Letter to Stephen H. Case Regarding the Bankruptcy Review Commission Small Business Working Group" (Nov. 8, 1996) ("I would submit that there would be little loss to the integrity of the system if disclosure statements were done away with altogether."); *see also* Geraldine Mund, "Letter to George Singer Regarding the September 7, 1996 Small Business Proposal" (Nov. 22, 1996); James Lawniczak, "Electronic Mail Message Regarding Judge Robert Martin's Proposals," (I . . . agree with Judge Martin that the disclosure

11 case simply cannot support the high costs of this process. Debtor's counsel is often left with the choice of submitting a poorly drafted plan and a perfunctory disclosure statement, or creating legal fees greater than the debtor can bear. The Commission even heard anecdotal evidence that the expected expense of drafting a plan and disclosure statement dissuades some businesses genuinely in need of rehabilitation from filing under Chapter 11 to begin with.

Accordingly, as more fully explained below, two keystones of the Working Group's Proposal are (1) the promulgation of easy-to-use, standard forms for disclosure statements and Chapter 11 plans for small business cases;¹⁶¹⁸ and (2) granting the court broader discretion to combine the disclosure and confirmation hearings in all small business cases or waive the filing of a disclosure statement altogether in appropriate cases. Lifting onerous disclosure requirements is an important step forward in making Chapter 11 more efficient for small businesses.

Therefore, the Working Group proposes several Recommendations. First, the courts, after notice and a hearing, should have the power to waive or modify the disclosure requirements to adapt them as appropriate on a case-by-case basis.¹⁶¹⁹ Second, the Rules Committee should promulgate standard-form disclosure statements and plans of reorganization for small business debtors.¹⁶²⁰

In small Chapter 11 cases, the drafted-from-scratch, prospectus-type disclosure statement and separate disclosure hearing are not cost-effective. The high costs of this process are simply greater than most debtors can bear, and do not yield information to creditors that could not otherwise be provided by use of a standard form. Indeed, standard forms increase the likelihood that all required topics will be covered, as they are easier to use than custom-created documents.¹⁶²¹ To minimize a debtor's inadvertent failure to disclose significant information, the standard forms would provide a blank for other material information critical to making a decision on

statement be simplified. . .”).

¹⁶¹⁸ The Commission recommends that these standard forms be designed to facilitate the collection and dissemination of accurate and comprehensive data and statistics.

¹⁶¹⁹ Although courts already have power to modify the disclosure statement and plan confirmation process under 11 U.S.C. § 105(d)(2)(B), this power would be both expanded and modified to require that the small business debtor file and confirm a plan of reorganization within, respectively, 90 and 150 days.

¹⁶²⁰ These forms should be compatible with current statistical database systems and designed to facilitate the collection of reliable data.

¹⁶²¹ See Elizabeth L. Perris, “Letter to John Gose Regarding the Chapter 11 Special Track” (Feb. 18, 1997).

how to vote.¹⁶²² For all relevant compliance purposes, including compliance with applicable securities laws, these standard forms would serve as “safe harbors” for debtors electing to file them, but would not preclude any debtor from deviating from the forms, as long as the alternate filing complied with applicable requirements.

Competing Considerations. Virtually no opposition to the foregoing Proposals was expressed during the process by which the foregoing Recommendation was developed. It might be argued that relaxation of disclosure requirements might encourage some debtors to play “hide the ball”, where present law does not allow it. However, the Commission believes that the benefits of expense reduction and faster emergence from Chapter 11 outweigh these risks.

2.5.3 Reporting Requirements

To create uniform national reporting requirements to permit U.S. Trustees, as well as creditors and the courts, better to monitor the activities of Chapter 11 debtors, the Rules Committee shall be called upon to adopt, with a reasonable time after enactment, amended rules requiring small business debtors to comply with the obligations imposed thereunder. The new rules will require debtors to file periodic financial and other reports, such as monthly operating reports, designed to embody, upon the basis of accounting and other reporting conventions to be determined by the Rules Committee, the best practical balance between (i) on the one hand, the reasonable needs of the court, the U.S. Trustee, and creditors for reasonably complete information and (ii) on the other hand, appropriate affordability, lack of undue burden, economy and simplicity for debtors. Specifically, the Rules Committee, shall be called upon to prescribe uniform reporting as to:

- a. the debtor’s profitability, i.e., approximately how much money the debtor has been earning or losing during current and relevant recent fiscal periods;**
- b. what the reasonably approximate ranges of projected cash receipts and cash disbursements (including those required by law or contract and those that are discretionary but excluding prepetition debt not lawfully payable after the entry of order for relief) for the debtor appear likely to be over a reasonable period in the future;**

¹⁶²² *Id.* Such forms have been successfully created and used in the District of Oregon.

- c. how approximate actual cash receipts and disbursements compare with results from prior reports;**
- d. whether the debtor is or is not (i) in compliance in all material respects with postpetition requirements imposed by the Bankruptcy Code and the Bankruptcy Rules and (ii) filing tax returns and paying taxes and other administrative claims as required by applicable nonbankruptcy law as will be required by the amended statute and rules and, if not, what the failures are, how and when the debtor intends to remedy such failures and what the estimated costs thereof are; and**
- e. such other matters applicable to small business debtors as may be called for in the best interests of debtors and creditors and the public interest in fair and efficient procedures under Chapter 11.**

A major objective of the Commission has been to improve techniques for early identification of those debtors which have a reasonable probability of succeeding in Chapter 11 and those which do not. Under present practice, fulfillment of this objective is sometimes difficult because basic business data about the enterprise are often not available. The majority, but not all, of bankruptcy jurisdictions require the prompt and regular filing of useful financial reports. Furthermore, while some courts have held that a debtor's failure to file monthly operating reports or other essential financial documentation constitutes cause to dismiss or convert a Chapter 11 case,¹⁶²³ nothing in the Bankruptcy Code or Rules expressly requires routine financial reporting during the pendency of a proceeding.¹⁶²⁴ Thus, the Commission proposes to amend

¹⁶²³ See *In re Tornheim*, 181 B.R. 161, 164 (Bankr. S.D.N.Y. 1995)(concluding that, although not specifically enumerated, the debtor's failure to file monthly operating reports as required by the United States trustee may constitute cause for dismissal), *appeal dismissed*, 1996 WL 79333 (S.D.N.Y. 1996); *In re Great American Pyramid Joint Venture*, 144 B.R. 780, 790 (Bankr. W.D. Tenn. 1992) (failure to file monthly operating report).

¹⁶²⁴ FED. R. BANKR. P. 2015 imposes only the following minimal duties on the Chapter 11 debtor to keep records, make reports, and give notice of its bankruptcy filing. The duties are imposed at the discretion of the court and, apart from the unlikely possibility of dismissal or conversion under section 1112(b), there are no sanctions for failure to comply with the rule:

- (a) Trustee or Debtor in Possession. A trustee or debtor in possession shall (1) . . . if the court directs, in a Chapter 11 reorganization case file and transmit to the United States trustee a complete inventory of the property of the debtor within 30 days after qualifying as a trustee or debtor in possession, unless such an inventory has already been filed; (2) keep a record of receipts and the disposition of money and property received; . . . (4) as soon as possible after the

the Bankruptcy Code or Rules to expressly require the periodic filing of financial and other reports, such as monthly operating reports, and the filing of schedules and statements within thirty days postpetition. Such reporting will assist the U.S. Trustees and the court in determining the appropriateness of dismissal or conversion of a case.¹⁶²⁵

Competing Considerations. It may be argued that the expense and burden of enlarged reporting will impose a “break-the-back” additional burden on the small, entrepreneurial enterprise seeking to recapitalize in Chapter 11. The Commission concedes that the requirement, if adopted, would impose additional burdens. These burdens may well result in the failure of some Chapter 11 cases. However, the conclusion behind the Recommendation is that once the debtor has elected to seek protection, it should live in a fishbowl so that all can assess the quality of its performance. Also, requiring additional reporting, while expensive and burdensome, especially for the very small business, may well impose and discipline that will assist rehabilitation, not to mention a possibly salutary education-in-management experience for entrepreneurs in Chapter 11.

commencement of the case, give notice of the case to every entity known to be holding money or property subject to withdrawal or order of the debtor . . . ; (5) in a Chapter 11 reorganization case, on or before the last day of the month after each calendar quarter until a plan is confirmed or the case is converted or dismissed, file and transmit to the United States trustee a statement of disbursements made during such calendar quarter and a statement of the amount of the fee required pursuant to 28 U.S.C. § 1930(a)(6) that has been paid for such calendar quarter. . .

(d) **Transmission of Reports.** In a Chapter 11 case the court may direct that copies or summaries of annual reports and copies or summaries of other reports shall be mailed to the creditors, equity security holders, and indenture trustees. . . .

FED. R. BANKR. P. 2015 (1991).

¹⁶²⁵ The Association of Insolvency Accountants (“AIA”) supports requiring debtors to submit uniform operating reports; however, the AIA has proposed that the focus on cash flow statements be on cash flow from operating activities of the business (EBITDA--earnings before interest, taxes, depreciation and amortization). The AIA also proposes that the reports clearly distinguish cash flows from operations from those related to liquidation and other nonoperating, extraordinary activities. Simple schedules of cash receipts do not take into account any estimate of the administrative obligations being incurred by the debtor. See Grant W. Newton, “Letter from the Association of Insolvency Accountants to the Bankruptcy Review Commission” (not dated).

2.5.4 *Duties of the Debtor in Possession*

The debtor is required to:

- a. append to the voluntary petition or, in an involuntary case, to file within three days after the order for relief, either (A)(i) its most recent balance sheet, statement of operations and cash-flow statement and (ii) its most recent federal income tax return or (B) a statement made under penalty of perjury that no such financial statements have been prepared or that no federal income tax return has been filed or (C) both;
- b. attend meetings, at which the debtor is represented by its senior management personnel and counsel, scheduled by the court, the U.S. Trustee, or the Bankruptcy Administrator including, but not limited to initial debtor interviews, court-ordered scheduling conferences, and meetings of creditors convened under 11 U.S.C. § 341;
- c. file all schedules and statements of financial affairs for small business debtors within the limits set by the Bankruptcy Rules, unless the court, upon notice to the U.S. Trustee and a hearing, grants an extension, which extension or extensions shall not, in any event, exceed thirty (30) days after the order for relief absent extraordinary and compelling circumstances;
- d. comply with postpetition obligations, including but not limited to the duties to: file tax returns, maintain appropriate and reasonable current insurance as is customary and appropriate to the industry, and timely pay all administrative expense tax claims, except those being contested by appropriate proceedings being diligently prosecuted;
- e. create within ten (10) business days of the entry of order for relief (or as soon thereafter as possible in case all banks contacted during the first ten (10) business days decline the business) separate deposit accounts with a bank or banks in which the debtor shall be required to timely deposit, until a plan is confirmed or the case is dismissed or converted or a trustee is appointed, after receipt, all taxes collected or withheld by it for governmental units. In compelling circumstances, the court may dispense with these requirements after notice and a hearing;

f. allow the U.S. Trustee or its designated representative to inspect the debtor's business premises, books and records at reasonable times on reasonable prior written notice to the debtor.

Comments. When Congress fashioned a consolidated approach to business rehabilitations, an underlying assumption was that debtors-in-possession would work together with active committees of creditors in negotiating a plan of reorganization.¹⁶²⁶ The role of committees was also viewed by Congress to be integral to the “supervision of the debtor in possession” and would serve to “protect their constituents’ interests.”¹⁶²⁷

Available data, however, indicate that creditors are apathetic in the vast majority of business bankruptcies.¹⁶²⁸ Indeed, national statistics reveal that a committee of creditors was constituted in only 15.3% of the 8,606 pending Chapter 11 cases filed between January 1993 and January 1996.¹⁶²⁹ In other words, 84.7% of Chapter 11 lacked the participation and “supervision” of a creditors’ committee that

¹⁶²⁶ See H.R. REP. NO. 595, 95th Cong., 1st Sess. 401 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6357 (indicating that committees of creditors and equity security holders “will be the primary negotiating bodies for the formulation of the plan or reorganization”). Congress believed that:

Under the consolidated reorganization chapter, the procedure will be a combination of features of current Chapters X and XI. *There will be at least one committee in each case.* Because unsecured creditors are normally the largest body of creditors and most in need of representation, the bill *requires* that there be a committee of unsecured creditors.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 235 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6195 (emphasis added). *But see* Richard B. Levin, “Letter to Stephen H. Case regarding the NBRC Small Business Working Group Proposal” (April 15, 1997)(citing the House Committee Report which noted that “[t]he notion of creditor control, while still theoretically sound, has failed in practical terms. Creditor control in bankruptcy cases is a myth.”).

¹⁶²⁷ See *supra* note 1626. See also 11 U.S.C. § 1102 (1978) (amended)(providing that “the court *shall* appoint a committee of creditors holding unsecured claims”)(emphasis added).

¹⁶²⁸ SENATE COMM. ON THE JUDICIARY, 103D CONG., REPORT ON S.540 at 43 (Oct. 28, 1993).

¹⁶²⁹ SUMMARY BY CIRCUIT OF CREDITOR COMMITTEE DATA, EXECUTIVE OFFICE OF UNITED STATES TRUSTEES (February 21, 1996). *Accord* LINDA E. STANLEY, Chapter 11 STATISTICS BY BUSINESS TYPE & YEAR, DEVELOPED BY THE SAN FRANCISCO OFFICE OF U.S. TRUSTEE, Oct. 18, 1996 (reporting that a creditors’ committee was appointed in only 6 out of 119 Chapter 11 cases (5%) filed in the Northern District of California in 1995. In only 20 % of these cases was counsel to the committee appointed).

Congress envisioned would be a cornerstone to a consolidated chapter.¹⁶³⁰ The fusion of the previous relief Chapters has thus not resulted in the contemplated joint administration of the bankruptcy estate by debtors and creditors, but rather has led to a system dominated far too often by the exclusive and largely unsupervised direction of the debtor-in-possession.¹⁶³¹

Lack of creditor participation does not necessarily mean that creditors are satisfied with the manner in which Chapter 11 cases progress. In small cases, individual creditors often have too little at stake to justify the cost of active participation in the Chapter 11 case. Thus, creditors' lack of participation often reflects an unwillingness to "throw good money after bad," rather than an endorsement of the present system. As more fully explained below, for purposes of administrative supervision, the reforms proposed by the Commission substitute the U. S. Trustee for absent creditors.¹⁶³²

The foregoing considerations therefore indicate that the express statutory duties imposed on the debtor ought to be strengthened and made explicit.

Competing Considerations. It may be argued that these duties are both unnecessary and overly rigid and excessive. They are, it may be contended, unnecessary because existing law allows the U.S. Trustee and the court adequate latitude to monitor and supervise Chapter 11 cases. As the courts and the U.S. Trustee grow in quality and experience, which the Commission believes has been their consistent record over the years, then the statutory "strait jacket" proposed above will be a hindrance to wise administration of Chapter 11 cases, not a benefit. In addition, opponents of the Proposal may contend that there are too many duties and that the expense of compliance will itself cause the failure of some or many Chapter 11 cases. Lastly, some of the requirements that are imposed in the early days and weeks of the case will, it may be argued, unwisely divert the attention of the debtor's management and professionals from focusing on the business and the jobs it provides, for the sake of "mere compliance" which itself does little or nothing to address the critical problems of saving distressed business enterprises.

¹⁶³⁰ See *supra* notes 1626-1627 and accompanying text; see also A. Thomas Small, *Chapter 11: A Growing Cash Cow. Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331 (1993)

¹⁶³¹ See Lynn M. LoPucki, *The Debtor in Full Control--Systems Failure Under Chapter 11 of the Bankruptcy Code (Second Installment)*, 57 AM. BANKR. L.J. 247 (1983).

¹⁶³² J. James Jenkins, "Letter to the Commission regarding the Small Business Proposal" (April 14, 1997) (recognizing the importance of the U.S. Trustee in cases lacking creditor supervision).

2.5.5 Deadlines for Plan Filing and Confirmation

In small business cases only, require that the disclosure statement, if any, and plan must be filed within 90 days after the entry of order for relief, unless extended as permitted below. During this 90-day period, only the debtor may file a plan unless on request of a party in interest made during this period and after notice and a hearing, the court, for cause, orders otherwise. In small business cases only, require the plan to be confirmed within 150 days after the entry of order for relief, unless extended as permitted below.

In addition to simplifying the disclosure process, the Commission recommends that Congress reduce cost and delay by requiring the debtor to promptly file and confirm a plan of reorganization on an expedited basis. Reducing time spent in Chapter 11 has a predicted effect of reducing the direct and indirect costs of administering a Chapter 11 case, and thereby preserving assets for distribution to unsecured creditors.¹⁶³³

To ensure that the court promptly concludes the plan-confirmation process, the Commission recommends that the court rule on the plan within sixty days of the date on which the plan was filed.¹⁶³⁴ Allowing the court sixty days to make a ruling appropriately balances the important need for creditors to receive notice of the plan confirmation hearing and adequate time to review the plan and prepare objections and the need to reduce delay in the plan confirmation process.

Competing Considerations. Ninety days, it may be argued, is not a reasonable amount of time to allow the debtor to develop a feasible plan,¹⁶³⁵ which can often not be developed until one or more events occur, such as negotiating terms for restructuring secured debts, finding a new source of capital, or decreasing the vacancy

¹⁶³³ *But see* Jim Kakalik, *Just, Speedy and Inexpensive? Summary of Main Findings, 5 FACTS & TRENDS, RAND INSTITUTE FOR CIVIL JUSTICE* (April 1997) (finding that reducing time to disposition through case-management procedures has a limited role in reducing litigation costs).

¹⁶³⁴ *See* 11 U.S.C. § 362(e)(1994) (requiring the court to rule on a request to modify the stay within thirty days).

¹⁶³⁵ Existing Chapter 12 also requires the debtor to file a plan no later than 90 days after the order for relief. 11 U.S.C. § 1221 (1994). *But see*, The Honorable Geraldine Mund, "Letter to the National Bankruptcy Review Commission Regarding the Proposal of the Small Business Working Group Dated March 27, 1997" (May 13, 1997) ("It seems to take about 45 days for the 341(a) hearing, and I believe that 90 days is simply too short for the debtor to prepare a quality product. I found that 120 days was more reasonable.").

rate of rental properties.¹⁶³⁶ Moreover, early in a Chapter 11 case, the debtor is preoccupied with schedules to prepare, motions to employ professionals, cash collateral motions, and the like.¹⁶³⁷ Finally, a debtor whose books and records have not been properly maintained may need several months to develop a plan which complies with the Bankruptcy Code's confirmation requirements.¹⁶³⁸ Also, it may be contended, the short fuse for plan confirmation does not take adequate account of the need for time-consuming negotiations with creditors and the vagaries of time, such as weather and vacation season in the summer.

The Commission has concluded, however, that the opportunity for extensions, discussed below, is an adequate safety valve for these concerns.

2.5.6 *Burden of Proof for Extensions of Deadlines*

Permit extensions of the deadlines for filing and approving disclosure statements, if any, and filing and confirming plans of reorganization only if the debtor, having duly noticed and appeared at the necessary extension hearing conducted and ruled upon prior to the expiration of the deadline, if any, and having carried the burdens of coming forward and persuasion, demonstrates by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time. No such deadline may be extended unless a new deadline is imposed at the time the extension is granted. The Bankruptcy and Judicial Codes will require the U.S. Trustee, as the case may be, to be a recipient of notice of extension hearings and to participate actively therein, in order to assure, to the maximum extent feasible, that the interests of the public are protected when determinations are made as to whether small business debtors receive extensions and have proven by a preponderance of the evidence that it is more likely than not that they will confirm a plan within a reasonable time.

Comments. Some debtors who will be able to successfully emerge from Chapter 11 will need extensions of the disclosure statement and plan filing deadlines. These deadlines are not intended to derail valid reorganization efforts, but rather to

¹⁶³⁶ Terrance L. Stinnett, "Letter from Goldberg, Stinnett, Meyers & Davis Regarding the Small Business Working Group Proposals" (Nov. 22, 1996).

¹⁶³⁷ *E.g.*, William C. Beall, "Letter from Beall & Burkhardt to the National Bankruptcy Review Commission Regarding the Small Business Working Group Proposal" (Jan. 13, 1997).

¹⁶³⁸ *National Bankruptcy Review Commission: Hearings Before the Working Group on Small Business Bankruptcy* (Sept. 19, 1996) (testimony of Judge Lisa Hill Fenning).

achieve early dismissal or conversion of those cases which have no genuine prospect of confirming a plan, and therefore no business benefitting from the protections of Chapter 11. To implement this concept, the Commission proposes that debtors requiring deadline extensions must bear the burden of proof to establish entitlement thereto by a “more likely than not” standard.

This standard is not thought to be highly onerous. It would require any debtor needing an extension to bear the burden of coming forward and of persuasion to establish, by a preponderance of the evidence, that the debtor has more than a fifty percent chance of confirming a plan. A frame of reference for the court to use in making this finding would be whether in a hypothetical sample of fifty cases substantially similar to that before the court, at least twenty-six would confirm a plan.

Competing Considerations. Some may contend that the standard of proof, even when set low at the “preponderance” standard will be too onerous for some businesses to meet. It may also be contended that so many businesses will need extensions that the courts will become highly clogged with Chapter 11 extension hearings.

The Commission has concluded, however, that the benefits of a statutory mandate to “make it or get out” will provide a salutary discipline to the process, which will discourage many debtors with no reasonable prospects for viability from filing to begin with, thus reserving the precious time of the courts for cases where the facts justify the need for judicial attention.

2.5.7 Scheduling Conferences

Require the bankruptcy court to promptly conduct at least one on-the-record scheduling hearing, on notice to the U.S. Trustee and the debtor’s 20 largest unsecured creditors to be sure that the deadlines discussed above are met except that no such hearing is required if an agreed order is filed by the debtor and U.S. Trustee and approved by the court after notice and hearing. The court shall also conduct such other scheduling hearings and status conferences as it deems fit and proper. Whenever possible, these hearings shall be scheduled in conjunction with other mandatory events so as to minimize to the most reasonable practicable extent, the time of debtor personnel spent in court and at official meetings.

Comments. Whether to require the court to hold at least one status conference has sparked controversy. Proponents of a mandatory, on-the-record status conference agree with the Commission that such a conference would quicken

the pace for disposition of a Chapter 11 plan¹⁶³⁹ by involving the power and prestige of the court and the authority inherent in court orders.¹⁶⁴⁰

Data from the Central District of California support required conferences.¹⁶⁴¹ In a study of Chapter 11 cases filed over a six-year period, Judge Bufford found that case management techniques of one judge, the Honorable Geraldine Mund,¹⁶⁴² (applied to 81.2% of Chapter 11 cases), which did *not* include a judicial status conference, shortened by 24.1% the time to confirmation of a plan; reduced by 44.1% the time to conversion to a case under another Chapter ; and shortened by 53.4% the time to dismissal of a typical nonviable Chapter 11 case.¹⁶⁴³ In a more expansive study of the case management techniques of six judges, Marcy J.K. Tiffany, U.S. Trustee for Region XVI, challenged Judge Bufford's conclusions, attributing a portion of delay reduction to general case management techniques, a portion to judicial status conferences, and the another part to the active role of the U.S. Trustee.¹⁶⁴⁴ According to Ms. Tiffany's data, *the most dramatic decreases in the days to dismissal of a Chapter 11 case resulted from a combination of U.S. Trustee motions and judicial status conferences.*¹⁶⁴⁵

A number of commentators, however, including one member of the Commission, have challenged these conclusions, arguing that status conferences are

¹⁶³⁹ See, e.g., American College of Bankruptcy, "Questionnaire Based on Focus Group Reports" (Jan. 31, 1997); see also Terrance L. Stinnett, "Letter from Goldberg, Stinnett, Meyers & Davis Regarding the Small Business Working Group Proposals" (Nov. 22, 1996); see also Jim Kakalik, *Just, Speedy and Inexpensive? Summary of Main Findings*, 5 FACTS & TRENDS, RAND INSTITUTE FOR CIVIL JUSTICE (April 1997) (finding that case-management procedures have a substantial effect on time to disposition, but a limited role in reducing litigation costs).

¹⁶⁴⁰ See Elizabeth L. Perris, "Letter to John Gose Regarding the Chapter 11 Special Track" (Feb. 17, 1997) ("One of the purposes of the scheduling conference is to inventory the impediments to confirmation and to set deadlines for the debtor to act to remove those deadlines. Such deadlines may include, without limitation, the filing of past-due prepetition tax returns, the commencement of litigation, or the filing of a claim objection.").

¹⁶⁴¹ See Samuel L. Bufford, *Chapter 11 Case Management and Delay Reduction: An Empirical Study*, 4 AM. BANKR. INST. L.R. 85 (1996).

¹⁶⁴² Judge Mund followed the process developed by Judge A. Thomas Small, described below.

¹⁶⁴³ *Id.* at 85, 113-14.

¹⁶⁴⁴ Marcy J.K. Tiffany, *Fast Track, Statistics and Delay Reduction: A Comparative Analysis* at 18-20 (unpublished manuscript on file with the author and the National Bankruptcy Review Commission)(Oct. 11, 1996).

¹⁶⁴⁵ *Id.* at 20-21.

an administrative duty that should be performed by U.S. Trustees, rather than resource-strapped judges.¹⁶⁴⁶ One commentator, the Honorable A. Thomas Small, supported his criticism of mandatory status conferences with data from Chapter 11 cases filed in the Eastern District of North Carolina from October, 1992 to October, 1996. Based on these data, Judge Small concludes that Chapter 11 cases can be effectively managed without “elaborate and expensive conferences.”¹⁶⁴⁷ Rather than hold routine status conferences to expedite the processing of Chapter 11 cases, Judge Small, like Judge Mund, implements several simple procedures: (i) entry of an order at the outset of the case setting a plan confirmation deadline; (ii) conditional approval of the disclosure statement; and (iii) a combined hearing on the disclosure statement and plan confirmation.¹⁶⁴⁸

There is no question that Judge Small and his colleagues expeditiously and successfully administer Chapter 11 cases in their district. For example, Judge Small’s data reveal a remarkably high confirmation rate of 68.3%, and a quick confirmation speed of 7 months, as opposed to a 12.5 month confirmation speed in the Central District of California. With respect to *dismissed* Chapter 11 cases, the average speeds from filing to dismissal in the Eastern District of North Carolina and the Central District of California are comparable at, respectively, 5.6 months and 5.3 months. Thus, with respect to confirmation and dismissal speeds, one possible conclusion is that status conferences are irrelevant to effective case management.

Comparison of *conversion* speeds, however, reveals that Chapter 11 cases in the Central District of California are dismissed at a significantly faster pace, 5 months, than are Chapter 11 filings in the Eastern District of North Carolina, where the conversion speed is 9 months. Interestingly, prior to implementation of judicial status conferences and the increased activity of the U.S. Trustee in the Central District of California, the “conversion speed” of Chapter 11 cases in the Central District of California was also nine months. Thus, it would appear from these limited samples that status conferences can significantly reduce delay in at least one class of Chapter 11 debtors, *i.e.*, those which should have filed Chapter 7 at the outset.

Based on the data as well as anecdotal evidence, the Commission has concluded that judges should be required to promptly hold at least one on-the-record status conference for Chapter 11 debtors.¹⁶⁴⁹ No status conference would be required

¹⁶⁴⁶ *E.g.*, *National Bankruptcy Review Commission: Plenary Hearings* (Feb. 21, 1997)(testimony of The Honorable Robert E. Ginsberg).

¹⁶⁴⁷ A. Thomas Small, “Letter to Stephen H. Case and the National Bankruptcy Review Commission Regarding the Small Business Proposal” (Feb. 21, 1997).

¹⁶⁴⁸ A. Thomas Small, *supra* note 1569.

¹⁶⁴⁹ *See* Elizabeth L. Perris, “Letter to John Gose Regarding the Chapter 11 Special Track”

however, if the debtor and U.S. Trustee were able to file an agreed scheduling order with the court prior the judicial scheduling conference. The status conference or the agreed order will serve an important function of inventorying any impediments to confirmation and scheduling the resolution of those impediments early in the proceeding.

Competing Considerations. Most of the competing considerations are discussed at length in the preceding text. Also, the Association of Insolvency Accountants advocates a status conference held no more than 30 days postpetition to ascertain whether the business is viable.¹⁶⁵⁰

2.5.8 *Serial Filer Provisions*

Provide in the Bankruptcy Code that, with respect to any debtor (or any entity which has succeeded to substantially all the debtor's assets or business) which files a second case while another case is pending in which such debtor is the (or one of the) debtor(s) or in the event that it again becomes a debtor in a Chapter 11 case within two years after an order of dismissal of a Chapter 11 case in which it was the debtor has become a final order or a Chapter 11 plan has been confirmed, shall not be entitled to the section 362(a) stay unless, after it has become a debtor, it bears the burdens of coming forward and of persuasion, by a preponderance of the evidence, that (1) the new case has resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and (2) it is more likely than not that it will confirm a feasible plan, but not a liquidating plan, within a reasonable time. In cases involving such debtors when the owners have transferred the business to a new legal entity, owned and arranged by them, the section 362(a) stay would apply on filing but would be lifted on a verified, *ex parte* motion of the U.S. Trustee, with the right to have it reimposed upon a showing of (1) and (2) above. The Federal Rule of Civil Procedure governing injunctions applies to the court's award of a stay to the debtor.

Comments. The Commission has considered problems that might be created if certain debtors, *e.g.* those whose cases were dismissed owing to failure to prove entitlement to extensions, simply refile a Chapter 11 case. Unregulated, seriatim refilings would completely undermine the purpose of the small business rules. The

(Feb. 18, 1997).

¹⁶⁵⁰ See Grant W. Newton, "Letter from the Association of Insolvency Accountants to the Bankruptcy Review Commission" (undated).

Commission has concluded that a stringent prohibition on re-filing is not justified, however, since genuine changes in circumstances may have occurred to justify another trip to the courthouse. Accordingly, the Commission proposes a limited rule, applicable only to small business debtors who file a second case while the first case is pending or in the event that the it again becomes a debtor in a Chapter 11 case within two years after an order of dismissal in the prior case has become a final order or a plan has been confirmed. In these cases, the debtor would be denied the protection of the section 362(a) stay unless, after it becomes a debtor, it bears the burdens of coming forward and of persuasion, by a preponderance of the evidence, that (1) the new case has resulted from circumstances beyond the control of the debtor and (2) the debtor is more likely than not to confirm a Chapter 11 plan, other than a liquidating plan, within a reasonable time. In cases involving such debtors when the owners have transferred the business to a new legal entity, owned and managed by them, the section 362(a) stay would apply on filing but would be lifted on verified, *ex parte* motion of the U.S. Trustee or any party in interest, with the right to have it reimposed upon a demonstration of (1) and (2) above. The Federal Rule of Civil Procedure governing injunctions would apply to the court's award of a stay to the debtor.¹⁶⁵¹

Competing Considerations. It may be argued that the incidence of repeat small business filers is too trivial in amount to justify the attention it gets in the foregoing Proposal. Moreover, like other provisions of the Commission, it may be contended, the serial-filing requirement is simply too onerous for the American economy in times of severe financial distress, when many sound businesses might need repeated opportunities to file.

2.5.9 Expanded Grounds for Dismissal or Conversion and Appointment of Trustee

a. Modify section 1112 to read as follows:

(b)(1) Except as provided in subsection (c) of this section or in section 1104(a)(3) of this title, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court shall convert a case under this chapter to a case under Chapter 7 of this title or shall dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, where movant establishes cause, except that such relief shall not be granted if the debtor or another party in interest objects and establishes both:

¹⁶⁵¹ FED. R. CIV. P. 65.

- (A) that it is more likely than not that a plan will be confirmed within a time as fixed by this title or by order of the court; and
 - (B) if the cause is an act or omission of the debtor:
 - (i) that there exists a reasonable justification for the act or omission; and
 - (ii) that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion unless the movant expressly consents to a continuance for a specific period of time or there are compelling circumstances beyond the control of the debtor which justify an extension.
- (2) For purposes of this subsection, cause includes:
- (A) substantial or continuing loss to or diminution of the estate;
 - (B) gross mismanagement of the estate;
 - (C) failure to maintain appropriate insurance;
 - (D) unauthorized use of cash collateral harmful to one or more creditors;
 - (E) failure to comply with an order of the court;
 - (F) failure timely to satisfy any filing or reporting requirement established by this title or by applicable rule;
 - (G) failure to attend the section 341(a) meeting of creditors or an examination ordered under Bankruptcy Rule 2004;
 - (H) failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee or;
 - (I) failure timely to pay taxes due after the order for relief or to file tax returns due after the order for relief;
 - (J) failure to file or confirm a plan within the time fixed by this title or by order of the court; and
 - (K) failure to pay any fees or charges required under Chapter 123 of title 28.
- (3) The court shall commence the hearing on any motion under this subsection within 30 days after filing of the motion, and shall decide the motion within 15 days after commencement of the hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

b. Additional Grounds for Appointment of Trustee

Add the following new section to 11 U.S.C. § 1104:

- (a)(3) where grounds exist to convert or dismiss the case under section 1112 of this title, but the court determines that the appointment of a Chapter 11 trustee is in the best interests of creditors and the estate.**

Comments. Perhaps the most difficult problem in reforming Chapter 11 for small business cases is to find a way to identify both promptly and reliably those cases that have no genuine prospects for reorganization. It is important to preserve and protect the benefits of Chapter 11 to those debtors with genuine rehabilitation prospects. It is also important to limit the exceptional privileges of Chapter 11 to those cases in which creditors and the public benefit thereby.

Under current law it is easy to file a non-meritorious Chapter 11 case, but sometimes hard to remove such a case from Chapter 11. A business about to file bankruptcy is strongly encouraged to file under Chapter 11, whether or not it has any genuine prospect for rehabilitation. This is so because a Chapter 11 debtor gets the benefit of a special form of preliminary injunction, the automatic stay, while keeping control of all its assets, without making any initial showing of likelihood of confirming a plan of reorganization. In all other fields of American law, a party seeking preliminary injunctive relief must establish a likelihood of prevailing on the merits.¹⁶⁵² Chapter 11 reverses this usual burden of proof by imposing a heavy burden on a party seeking to dismiss a Chapter 11 case, convert it to Chapter 7, or appoint a Chapter 11 trustee. Many courts have held that any such action against the debtor-in-possession is an “extraordinary remedy.”¹⁶⁵³ This reversal of the ordinary burden of proof is not justified by the aggregate success of Chapter 11 cases. As noted previously, only about fifteen percent of Chapter 11 cases result in confirmation of a plan.¹⁶⁵⁴

The Proposal adopts a burden of proof halfway between existing Chapter 11 practice and the burden of proof imposed on nondebtor litigants seeking injunctive relief against creditor action. A debtor could continue to file under Chapter 11 and get the benefit of the automatic stay without making any initial showing of likelihood

¹⁶⁵² *E.g.*, *Rodriguez v. United States*, 66 F.3d. 95, 97 (5th Cir. 1995), *cert. denied*, ___ U.S. ___ 116 S.Ct. 1058 (1996).

¹⁶⁵³ *E.g.*, *In re Fisher & Son, Inc.*, 70 B.R. 7, 8 (S.D. Ohio 1986)

¹⁶⁵⁴ *See supra* note 1549 and accompanying text.

of confirming a plan. If the debtor failed to meet certain benchmarks while in Chapter 11, however, the burden would shift to the debtor to establish a likelihood of confirming a plan within a reasonable period of time.

Section 1112(b) of the Bankruptcy Code, which governs conversion or dismissal of a Chapter 11 case, already establishes a number of benchmarks of likely failure.¹⁶⁵⁵ The Commission recommends adding additional benchmarks to the current non-exhaustive list of ten examples of “cause” enumerated in section 1112(b). The party seeking conversion or dismissal (a creditor or the U.S. Trustee) would be required to show a material act, omission, or event identified in amended section 1112 as “cause” for conversion or dismissal. Moreover, if the moving party met this initial burden of proof, the burden would then shift to the debtor to show: (1) adequate justification or excuse for any act or omission of the debtor constituting “cause;” (2) that any such act or omission will be corrected promptly; and (3) that it is more likely than not that the debtor will confirm a plan within a reasonable period of time. If the debtor failed to establish this burden, the case would be converted or dismissed, or a Chapter 11 trustee appointed.¹⁶⁵⁶ The many witnesses who testified before the Commission helped identify the benchmarks that indicate likely failure of the Chapter 11 case or that otherwise justify requiring the debtor to show that confirmation of a plan is likely.

A debtor who continues to incur losses postpetition should be watched very closely by the U.S. Trustee and the bankruptcy judge. Not only do postfiling losses make reorganization less likely, but they also diminish the assets available to pay creditors. Section 1112 now provides for conversion or dismissal where there are continued postpetition losses and the moving party establishes that there is no reasonable likelihood of reorganization.¹⁶⁵⁷ Additional “causes” for conversion should include losses that are either continued or otherwise “significant,” and once such losses are established, the burden should fall upon the debtor to show that reorganization is likely.

Providing for dismissal or conversion of a debtor which is unable to perform certain basic duties, such as failing to disclose financial information, is appropriate

¹⁶⁵⁵ Section 1112(b), as originally codified, set forth nine examples of cause for conversion or dismissal of a Chapter 11 case. 7 COLLIER ON BANKRUPTCY ¶ 1112.04[5], 1112-30, 48-49 (Lawrence P. King et al. eds., 15th ed. 1996).

¹⁶⁵⁶ Section 1104 would also be amended to provide that the court could order the appointment of a Chapter 11 trustee where grounds to convert or dismiss exist but the court determines that appointment of a Chapter 11 trustee is in the best interests of the estate.

¹⁶⁵⁷ See 11 U.S.C. § 1112(b)(1) (1994).

because such debtor is unlikely to survive as an on-going concern.¹⁶⁵⁸ Failure to enforce reporting obligations harms both debtors, who may not learn valuable accounting skills, but it also deprives creditors of important economic information about the debtor which is needed to evaluate the feasibility of the debtor's plan. From a public policy perspective, it is only fair to require debtors, who enjoy the privilege of a broad injunction, to disclose information to creditors and the court.¹⁶⁵⁹

Once a debtor files a Chapter 11 petition, the automatic stay protects the debtor from actions by creditors, and allows the debtor a breathing spell during which to reorganize its affairs in an orderly manner, under the supervision and protection of the court. In these circumstances, the debtor should be able to comply with basic obligations of its business, such as filing tax returns¹⁶⁶⁰ and maintaining current insurance. Debtors who are unable to meet their minimal obligations under protected circumstances are also unlikely to be able to do so once their daily activities return to normal. Indeed, witnesses noted a high anecdotal correlation between failure to (i) file postpetition tax returns, (ii) pay postpetition taxes,¹⁶⁶¹ insurance and failure to

¹⁶⁵⁸ *National Bankruptcy Review Commission: Plenary Hearings* (Feb. 21, 1997)(testimony of Commissioner Jay Alix) at 111.

¹⁶⁵⁹ *See*, DISCUSSION OUTLINE, NEW MONTHLY OPERATING REPORT REQUIREMENTS UNITED STATES BANKRUPTCY COURT--NORTHERN DISTRICT OF CALIFORNIA, Jan. 1, 1995. This outlines explains the dual purpose of the monthly operating report:

The first [purpose] is to provide factual information to the creditors, the judges, and the Office of the United States Trustee regarding the financial progress of the debtor. The operating report is designed to provide a broad overview of the progress of the debtor toward effectuating a plan.

The second purpose is to benefit the debtor. The reason many businesses find themselves in Chapter 11 is that they lack financial discipline and/or financial expertise. By having the operational report due monthly, the debtor is forced to stop and review the financial occurrences of the past month. By having the operating report in a comparative format, hopefully the debtor will begin to view the current months trends in context to the prior months.

¹⁶⁶⁰ 28 U.S.C. § 960 provides as follows:

Tax Liability. Any officers or agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation

¹⁶⁶¹ Some courts have held that failure to pay postpetition taxes may constitute cause to convert or dismiss under section 1112 (b). *See, e.g., Berryhill v. United States In re Berryhill*, 189 B.R. 463, 466 (N.D.Ind. 1995).

confirm a plan of reorganization.¹⁶⁶² In addition there was a consensus among the witnesses that it is reasonable to require a Chapter 11 debtor-in-possession to meet these obligations in return for the protections of Chapter 11. As noted above, failure to meet these obligations would not result in automatic conversion, dismissal, or appointment of a trustee, but would require the debtor to show that it was likely to confirm a plan within a reasonable time.

The Working Group has received considerable anecdotal data supporting its conclusion that numerous debtors, suffering from cash shortages, finance their day-to-day operations by using cash withheld from employee paychecks or sales-tax revenues, or other like “trust fund” taxes, to pay bills and provide the business with working capital. This chronic problem is often witnessed by Chapter 7 trustees in cases converted from Chapter 11.¹⁶⁶³

The Commission proposes to remedy this abuse by requiring all small business debtors to establish, promptly after the petition is filed, segregated bank accounts for timely deposit of tax funds withheld or collected from third parties after the commencement of the case. This requirement will not pose problems for well managed debtors who, in or out of Chapter 11, would never use third-party tax funds for working capital. The Working Group’s proposed requirements would thus stop the practice of using government money for unauthorized business loans.

Competing Considerations. As to expanded grounds for conversion and dismissal, opponents of the Recommendation may contend that they are unnecessary, that existing law is adequate and that the new statute, if enacted, would encourage too much unwise and unnecessary litigation from creditors.

As to expanded grounds for appointment of Chapter 11 trustees, in small business cases, it may be contended, the enactment has no meaning because Chapter

¹⁶⁶² See Philip J. Hendel, “Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities” (Dec. 17, 1996) (“When no creditors’ committees are formed in smaller cases, a substantial administrative burden is imposed on the United States Trustee to monitor these cases in the public interest. Unfortunately, there are the cases that frequently present compliance problems such as non-payment of taxes, failure to file accurate or timely reports, failure to report cancellation of insurance, etc. . . . There are usually substantial administrative fees and expenses that have been paid to the professionals.”).

¹⁶⁶³ E.g., J. James Jenkins, “Letter to the Commission regarding the Small Business Proposal” (April 14, 1997) (noting that in the typical converted small Chapter 11 case there is no cash, wages are unpaid, payroll and sales taxes are unpaid, valuable property has been foreclosed upon, sold or is missing, employees are disgruntled, there may be allegations of theft, assumed executory contracts have created increased postpetition claims, professional fees are unpaid, tax returns are delinquent, and there are pre-planned foreclosures or other transactions which are benefitting insiders).

11 trustees do not function well in small business cases; those small business cases which need trustees, it may be contended, are almost always going to be converted to Chapter 7.

2.5.10 *Enhanced Powers of the United States Trustee and Bankruptcy Administrator*

Add a new subclause (e) to 11 U.S.C. § 341, and amend 28 U.S.C. § 586 (the general statute governing the powers and duties of the U.S. Trustee) and the Manual for Bankruptcy Administrators,¹⁶⁶⁴ (governing the duties of Bankruptcy Administrators) to require U.S. Trustees in every small business debtor case (except where they, in their reasonable discretion determine that the conduct enumerated below is not advisable in the circumstances):

(1)(a) to conduct an initial debtor interview (“IDI”) with the debtor as soon as practicable after the entry of order for relief but prior to the first meeting scheduled under Bankruptcy Code § 341(a). At the IDI, the U.S. Trustee shall, at a minimum, begin to investigate the debtor’s viability, inquire about the debtor’s business plan, explain the debtor’s obligations to file monthly operating reports and other required reports, attempt to develop an agreed scheduling order, and inform the debtor of other Chapter 11 obligations;

(b) when determined by the U.S. Trustee to be appropriate and advisable, to visit the appropriate business premises of the debtor and ascertain the general state of the debtor’s books and records and verify that the debtor has filed its tax returns. This visit should take place in connection with or reasonably promptly after the IDI (wherever possible, these events shall be combined with other events so as to minimize to the most reasonable practicable extent the amount of time of debtor personnel spent in court and at official meetings); and

(c) to review and monitor diligently on a continuous basis each debtor’s activities, with a view to identifying as promptly as possible those debtors which do not pass the

¹⁶⁶⁴ Section 302(d)(3)(I) of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554, 100 Stat. 3119, 3123, provides the statutory authority for the Judicial Conference of the United States to establish the bankruptcy administrator program.

test of being more likely than not to be able to confirm a Chapter 11 plan within a reasonable time; and

(2) in cases where, upon the basis of continuing review, monitoring or otherwise, the U.S. Trustee finds material grounds for any relief under Bankruptcy Code § 1112, to move the court promptly for relief.

Although many U.S. Trustees actively, carefully, and professionally supervise Chapter 11 debtors in possession and ensure prompt disposition of Chapter 11 proceedings, no statute imposes any clear duty to do so. The Commission has proposed to remedy this deficiency in several ways.

To expedite the identification of cases that are unlikely to reorganize and expedite the administration of small business cases, the U.S. Trustee will play a more active role throughout the Chapter 11 proceeding. At case commencement, the U.S. Trustee will be called upon to hold an “initial debtor interview” (“IDI”) with the debtor. The IDI is an informal forum, attended by the debtor and, if applicable, the debtor’s attorney, the general purpose of which is to familiarize the debtor with its Chapter 11 obligations and the role of the U.S. Trustee, and to familiarize the U.S. Trustee with the debtor’s case. The IDI also provides an opportunity for the U.S. Trustee and the debtor to jointly review the accuracy of the debtor’s schedules and statements, determine the debtor’s reorganization “game plan,” and agree to a scheduling order. In advance of the IDI, the U.S. Trustee will require the debtor to create a debtor-in-possession bank account, including separate deposit accounts for taxes collected or withheld by the debtor for governmental units, and to obtain current insurance for the debtor’s business.

In appropriate cases, the U.S. Trustee will visit and inspect the debtor’s business premises. It is intended that the U.S. Trustee has discretion about which debtors to visit and when. The Commission considers this flexibility important. In fulfilling its duties, the U.S. Trustees will develop standards and guidelines about how and when to use their resources in conducting visitations in order to maximize the benefits of this effort. The U.S. Trustee will diligently review and monitor small business debtors to ensure compliance with required financial reporting.

Competing Consideration. As to enlarging the powers of the U.S. Trustee the following competing considerations are among the most often advocated. First it is contended that, despite good intentions, ability, hard work and dedication, the staff of the U.S. Trustee program is never going to have the sophisticated business experience necessary make the subtle judgments necessary to determine which businesses “live” or “die” in Chapter 11. Second, it is contended that in times of budgetary restraint, the Congress can not be expected to appropriate the necessary funds for the U.S. Trustee program to adequately perform its duties.

The Working Group initially considered recommending appointment of an independent examiner, accountant, “licensed insolvency officer,”¹⁶⁶⁵ or other business viability expert.¹⁶⁶⁶ At the outset, the idea of an experienced expert assessing the debtor’s business viability had great appeal. In particular, the members of the Working Group were impressed by the excellent procedures employed in the United Kingdom which has a licensing program for persons who administer insolvent estates.¹⁶⁶⁷ Implementing a similar requirement in the Bankruptcy Code would have codified the notion that business analysis is as important in bankruptcy or even more important than litigation and other legal analysis, especially at the beginning of a case.¹⁶⁶⁸ Nonetheless, this Proposal received almost no support.¹⁶⁶⁹

Critics argued that a “monitoring agent” would duplicate the roles already served by bankruptcy judges, U.S. Trustees, Bankruptcy Administrators, and panel trustees. In addition, opponents predicted that appointing monitoring agents would create an army of unneeded professionals, whose credibility and effectiveness would be undermined by perceptions of agents as stereotypical “government

¹⁶⁶⁵ The Working Group has heard testimony that the United Kingdom insolvency system benefits from the participation of licensed insolvency experts. These professionals work in the private sector, are qualified and licensed, represent the debtor and work with debtors’ management, have business “turnaround” experience, have a duty to creditors, can be sued if negligent, and are temporary officers of the court with a duty to the court. See A. Mark Homan, “Letter to the National Bankruptcy Review Commission Small Business Working Group Describing the UK insolvency licensing regime” (Dec. 23, 1996); see also *Bankruptcy Reform--A Time for the Licensed Insolvency Officer (“LIO”)?*, Panel Discussion of the American Bankruptcy Institute (Dec. 1, 1995).

¹⁶⁶⁶ Stephen H. Case & George H. Singer, “Preliminary Staff Proposals of the Working Group on Partnerships, Small Business, and Single-Asset Realty” (July 2, 1996) (unpublished memorandum on file with the National Bankruptcy Review Commission).

¹⁶⁶⁷ See A. Mark Homan, “Letter to the National Bankruptcy Review Commission Small Business Working Group Describing the UK insolvency licensing regime” (Dec. 23, 1996).

¹⁶⁶⁸ *National Bankruptcy Review Commission: Plenary Hearings* 35-37 (Jan. 22 1997) (testimony of the Honorable Robert D. Martin, Chief Bankruptcy Judge of the Western District of Wisconsin) (describing the superior skills of accountants over lawyers to assess economic viability).

¹⁶⁶⁹ Stephen H. Case, Jennifer C. Frasier & George H. Singer, “Discussion Summary, September 19, 1996, Working Group on ‘Small Business’ Bankruptcy” (Oct. 8, 1996) (unpublished memorandum on file with the National Bankruptcy Review Commission). But see Grant W. Newton, Association of Insolvency Accountants, “Letter to the Bankruptcy Review Commission,” (not dated) (recommending that the U.S. Trustee appoint a small business examiner to determine the debtor’s viability. The examiner would have 15-20 days to make a visit to the business premises, complete his or her initial report, and file it with the court and the U.S. Trustee).

bureaucrats.”¹⁶⁷⁰ Furthermore, the appointment of monitoring agents would add an unwelcome new layer of costs onto an already expensive process.¹⁶⁷¹

After extensively investigating the purposes and operation of the U.S. Trustee and Bankruptcy Administrator programs,¹⁶⁷² the Commission has concluded that these programs have enormous potential to systematize early identification and disposition of economically defunct entities. Indeed, efficient procedures for administering Chapter 11 cases already exist in the Bankruptcy Administrator program,¹⁶⁷³ which operates only in Alabama and North Carolina.¹⁶⁷⁴ Despite the lack of any statutory directive to examine or supervise the conduct of debtors in possession, a number of dedicated U.S. Trustees have also added efficiency to the administration of Chapter 11.¹⁶⁷⁵ For example, the efforts of the U.S. Trustees for Regions 16 and 17 have contributed to a steady reduction in the number of days from case commencement to disposition.¹⁶⁷⁶ In San Francisco between January of 1992 and October of 1996, for instance, the median number of days from case commencement to conversion or dismissal has decreased from 10.8 months to 7.5 months.¹⁶⁷⁷

¹⁶⁷⁰ *Id.*

¹⁶⁷¹ Stephen H. Case & George H. Singer, “Working Group Meeting on Small Business & Single-Asset Real Estate” (July 22, 1996) (unpublished memorandum on file with the National Bankruptcy Review Commission).

¹⁶⁷² *See, e.g.*, Jennifer C. Frasier, “Discussion Summary, Meeting with the Region XVII of the United States Trustee” (Dec. 6, 1996)(unpublished memorandum on file with the National Bankruptcy Review Commission).; *see also* Stephen H. Case & Jennifer C. Frasier, “Discussion Summary, October 18, 1996, Plenary Session on ‘Small Business’ Bankruptcy” (Oct. 31, 1996) (unpublished memorandum on file with National Bankruptcy Review Commission).

¹⁶⁷³ In the Middle District of Alabama, for example, the number of days from the petition date to conversion or dismissal is only 6.1 months. Dwight H. Williams, “Letter to the National Bankruptcy Review Commission” (Dec. 5, 1996) (enclosing Chapter 11 data for the Middle District of Alabama for 1995).

¹⁶⁷⁴ Detailed guidelines for Bankruptcy Administrators are set forth in the *Manual for Bankruptcy Administrators*, Judicial Conf. Regulations and Director’s Guidelines for Bankruptcy Administrators (April 20, 1994).

¹⁶⁷⁵ The work of the U.S. Trustees also subject to detailed guidelines which are set forth in the *United States Trustee Manual* (Oct. 1996).

¹⁶⁷⁶ Marcy J.K. Tiffany, *Fast Track, Statistics, and Delay Reduction: A Comparative Analysis* (Oct. 1996) (unpublished article on file with the National Bankruptcy Review Commission) (analyzing case disposition rates for the Central District of California from 1989-1994. The author concludes that the administrative activities implemented by the United States Trustee significantly contributed to delay reduction in administration of Chapter 11 cases).

¹⁶⁷⁷ Linda E. Stanley, “Letter to the National Bankruptcy Review Commission” (Nov. 14,

The Commission believes that augmenting the statutory duties of the debtor-in-possession, described herein, combined with expansion of the U.S. Trustees' statutory duties and an affirmation of the procedures guiding Bankruptcy Administrators will provide an effective substitute for inactive creditors. For this reason, and concerns over the costs of alternative Proposals, the Working Group rejected its initial proposal to recommend appointment of independent viability experts in small business Chapter 11 cases.

1996) (enclosing Chapter 11 data for San Francisco from January 1992 to October 1996).