

**A Proposal for Amending Chapter 12 to Accommodate
Small Business Enterprises Seeking to Reorganize**

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Executive Summary

Today's small businesses have few options when they suffer financial distress. If they want to avoid liquidation, and if they are organized as a partnership or corporation, they must use Chapter 11 of the Bankruptcy Code. But judges, attorneys, and academics have known for years that Chapter 11 works poorly or not at all for small businesses. This law was designed for large corporations with extensive operations and complex capital structures, not small enterprises that depend critically on the skills of a single owner-manager and family members. The model for Chapter 11 was the publicly-traded manufacturer, not the local diner. As a result, many distressed small businesses are forced to wind down using antiquated state-law procedures instead of Chapter 11. If they do enter Chapter 11, their cases are often dismissed or converted to liquidation. The few that do succeed at reorganizing find that 20 percent or more of their assets were consumed by the administrative costs of the bankruptcy process.

There is a simple solution to this problem, and it already exists in another chapter of the Bankruptcy Code: Chapter 12, which now offers a reorganization opportunity for family farmers and family fishermen. This chapter provides a time-tested, successful model for efficient reorganization of small businesses. We recommend making it available to small businesses generally. With appropriate modifications, outlined in our proposal below, Chapter 12 would fill a gap in the reorganization laws for small businesses, save a significant number of viable small businesses from liquidation, and lower the costs of business failure for both small businesses and their creditors.

Our proposal begins with a statistical profile of small business bankruptcy, documenting the ill-fitting match between existing Chapter 11 and the problems of most small businesses. We then propose Chapter 12 as the appropriate solution and show that few legislative changes would be required to make this Chapter accessible to small businesses. The appendix presents the statutory amendments that would be necessary.

I. Motivation: Chapter 11 is a poor fit for small businesses

Bankruptcy judges, practitioners, and academics have known for decades that Chapter 11 works poorly or not at all for small businesses. There are many good reasons for this misfit. Fundamentally, Chapter 11 was conceived as a “big” business chapter with public companies as the model. Complex debt and asset structures arguably justify the SEC-style disclosures, multi-layered plans, voting and the like that characterize money-center Chapter 11 cases.¹ These same features make Chapter 11 too expensive, too complicated and too time consuming for small business debtors and their creditors.

Although a number of courts have fashioned local rules and practices that soften the unwelcoming aspects of Chapter 11,² they are limited to working with blunt tools, such as deadlines for submitting a plan and the threat of dismissal or conversion to Chapter 7. Some Local rules and practices have been counteracted by recent legislation (in 2005) that makes Chapter 11 less hospitable to small businesses by increasing disclosure requirements, compressing the time available, swamping cases with administration, and setting “drop dead” traps at every turn.³

¹See, e.g., Hon. Leif M. Clark, *Chapter 11—Does One Size Fit All?*, 4 AM. BANKR. INST. L. REV. 167, 170-75 (1996).

²See Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305 (1993); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 205-07 & nn.78-85 (2000) (“The initiative in dealing with [the small success rate of small businesses in Chapter 11] came from the courts. Beginning in the late 1980s, some judges began to use their discretionary power to create a system of case management under which they could quicken the pace of cases that were proceeding too slowly and could more rapidly dismiss, or convert to Chapter 7, cases that had poor prospects of successful rehabilitation. The best known of these methods came to be known as the ‘fast-track.’ In essence, the fast-track procedure provided for an early evaluation by an official equivalent to the U.S. Trustee of all cases filed, to determine if they should be subject to an accelerated deadline for filing the plan. There were no specific articulated guidelines for this determination, which was made case by case and was not confined to debtors below any defined size. If the case was one for which accelerated treatment was appropriate, the court would order the debtor to file a plan by a specified date, usually sixty to ninety days following the order for relief. In addition, instead of following the usual (indeed, it can be argued, the required) procedure of conducting a formal hearing on notice to approve the disclosure statement before acceptances of the plan were solicited, the court informally reviewed the disclosure statement and would provisionally approve it if it appeared adequate. The final approval hearing, with an opportunity afforded for objections to the statement, was postponed to be combined with the plan confirmation hearing. If the debtor missed the deadline for plan filing set by the court, the case could be dismissed or converted unless the debtor could show cause for the delay. A short extension may have been granted if the plan was not confirmable, but the debtor would not be allowed wide latitude in producing a timely confirmable plan.”) (footnotes omitted).

³See, e.g., 11 U.S.C. §§ 308 (small business debtor reporting requirements), 1116 (additional duties of a debtor or trustee in a small business case); 1121(e) (reorganization plan must be submitted within 300 days), 1129(e) (plan must be confirmed within 45 days after plan is filed); 28 U.S.C § 586(a)(7) (establishing expanded U.S. Trustee duties and responsibilities in small business cases). See also Hon. A. Thomas Small, *If You Fix It, They Will Come—A New Playing Field for Small Business Bankruptcies*, 79

This section presents a statistical profile of the challenges small businesses experience in Chapter 11. Drawing on a wide range of empirical studies, there are four fundamental flaws in the current reorganization process for small businesses:

1. **Excessive Secured Creditor Influence:** Chapter 11 gives secured creditors excessive influence over the process,
2. **Monitoring Deficits:** Chapter 11 fails to give the judge or trustee sufficient information to monitor the firm's viability,
3. **High Costs:** Chapter 11 generates exorbitant administrative costs,
4. **Obstacles to Reorganization:** Chapter 11 includes a set of procedures (due in part to the reforms of 2005) that create serious roadblocks to reorganization.

Section II explains how Chapter 12 can remedy these problems.

A. Small Business Chapter 11s: Basic Facts

Several recent studies have produced basic facts about the small business Chapter 11 process, including:

- IL Study: analyzed bankruptcy filings during 1998 and 2006 in the Northern District of Illinois. The study excluded filings by non-corporate, non-profit, and real estate businesses.⁴
- NY/AZ Study: analyzed filings between 1995 and 2001 in the Southern District of New York and the District of Arizona. The study excluded cases that were dismissed or converted to Chapter 7.⁵
- Multi-District Study: analyzed filings during 1998 and 2006 in a variety of districts (23 districts in 1998 and 9 in 2006). The study includes filings by individuals, partnerships, and corporations.⁶

AM. BANKR. L.J. 981, 982 (2005) (“These provisions probably will not reduce costs, and certainly do not address most of the roadblocks that confront a small business Chapter 11 debtor.”).

⁴ Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381 (2007); Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005); and Douglas G. Baird & Edward R. Morrison, *Adversary Proceedings: A Sideshow*, 79 Am. Bankr. L.J. 951 (2005).

⁵ This study produced Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study*, working paper (2007), and Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. Fin. 1280 (2006).

⁶ Papers from this study include Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L. J. 499 (1999).

- D&B Studies: analyzed Dun & Bradstreet data on small business closures. One study analyzed distressed businesses in Cook County during the period 1998 to 2005.⁷ Another analyzed a nationally representative sample of small business closures during 2004 and 2006.⁸ Both studies included data on corporations, proprietorships, and partnerships that filed for bankruptcy or shut down without filing.
- Tax Studies: several papers have studied the pervasiveness and composition of small business tax debts.⁹

These studies report the following patterns:

Small businesses have relatively simple capital structures and many wind down or reorganize without filing for bankruptcy. Among businesses with less than \$200,000 in assets, the NY/AZ Study found, the median firm has only 1 or 2 secured creditors, neither of which is usually a bank.¹⁰ The number of unsecured creditors is fewer than 20 for the median firm, and a bank is rarely, if ever, among these creditors.¹¹ Due to the simplicity of their capital structures, distressed small businesses frequently resolve their distress without filing for bankruptcy. For example, the D&B Studies found that 80 percent of distressed businesses wind down or reorganize without filing. Bankruptcy is most attractive to firms with a relatively large number of creditors (e.g., 3 or more secured creditors).¹²

Secured debt accounts for a large share of total debt and assets, but significant value remains for unsecured creditors. Data from the IL Study, for example, show that secured debt accounted for 23 percent of total debt and 51 percent of total assets in the median firm.¹³

Administrative costs of Chapter 11 are significant. Looking across both Chapter 7s and confirmed Chapter 11s, the NY/AZ found that median professional fees equaled 23% of asset value (as reported at filing) among firms with assets worth less than \$100,000. Fees equaled 4.9% of assets among firms with assets worth between \$100,000 and \$1 million and about 1% among larger firms.¹⁴ Another study, of individual and business Chapter 11s in six geographically diverse districts between 1986 and 1993, found administrative costs equal to 3.5

⁷ Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255 (2009).

⁸ Edward R. Morrison, *Bankruptcy's Rarity, Small Business Workouts in the United States*, 5 Eur. Company & Fin. L. Rev. 172 (2008); Edward R. Morrison, *Small Business Bankruptcy and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, Report Submitted to the Small Business Administration (2008).

⁹ These include Rafael Efrat, *The Tax Debts of Small Business Owners in Bankruptcy*, 24 Akron Tax L. J. 175 (2009); Rafael Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, 4 Hastings Bus. L. J. 175 (2008); Baird, et al., *Dynamics of Large and Small Chapter 11 Cases*, *supra* note 5; and Baird & Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, *supra* note 4.

¹⁰ Baird, Bris & Zhu, *supra* note 2, at 18-9.

¹¹ *Id.*

¹² Morrison, *Small Business*, *supra* note 1, at 6.

¹³ These statistics were computed for this proposal.

¹⁴ Bris, Welch & Zhu, *supra* note 2, at 1282

percent of assets (at filing) in the median case (“Lawless, et al., Study”).¹⁵ Practitioners claim that these costs exceed those of comparable state procedures such as assignments for the benefit of creditors.¹⁶

Administrative costs and priority tax claims consume the bulk of unencumbered property in confirmed Chapter 11s. The NY/AZ study calculated the median recovery rate for creditors holding non-priority unsecured claims. It was zero among firms with assets (at filing) under \$200,000 and around 3 percent among firms with assets under \$2 million. Priority tax claims, in particular, constituted a large fraction of total debt, accounting for 20 percent or more of unsecured debt among firms with assets under \$2 million.¹⁷ The Lawless et al., Study found that professional fees and other administrative expenses consumed about 18 percent of distributions to unsecured creditors in the median case.¹⁸

Most Chapter 11s terminate in dismissal or conversion to Chapter 7. The IL study found that, among firms with debt under \$2 million, dismissal or conversion occurred in 77% of cases filed during 1998 and 66% of cases filed during 2006.¹⁹ Similarly, the Multi-District study found dismissal or conversion in 70% of cases filed in 1994 and 67% of those filed in 2002.²⁰ These patterns are consonant with those reported by the National Bankruptcy Review Commission, which observed that “only a small fraction of the Chapter 11 cases filed nationwide end in confirmation of a plan of reorganization.”²¹ Failure to reach confirmation, however, is not necessarily an indicator of failure. A “successful” Chapter 11 could culminate in dismissal because the debtor has resolved its problems or has found a buyer.²²

¹⁵ Robert M. Lawless & Steven Ferris, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. Pitt. L. Rev. 629, 651 (1999-2000).

¹⁶ See, e.g., Melanie Rovner Cohen & Joanna L. Challacombe, *Assignment for the Benefit of Creditors—Contemporary Alternatives for Corporations*, 2 DePaul Bus. L. J. 269, 270 (1990) (“In contrast to a Chapter 7 liquidation under the Bankruptcy Code, an assignment [for the benefit of creditors (ABC)] is generally more efficient, less costly, of shorter duration, more successful in terms of the value received for the assets and amounts paid to creditors and more tailored to the needs of debtors and their creditors.”); David S. Kupetz, *Assignment for the Benefit of Creditors: Advantageous Vehicle for Selling and Acquiring Distressed Enterprises*, 6 J. Private Equity 16, 18 (2003) (“Compared to bankruptcy liquidation, assignments may involve a faster and more flexible liquidation process.”); Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High-Tech Firms*, 82 Wash. U. L. Q. 1375, 1392-93 (2004) (concluding, based on interviews with practitioners, that “the net cost of the [ABC] process seems to be less than a bankruptcy proceeding”); Bruce C. Scalabrino, *Representing a Creditor in an Assignment for the Benefit of Creditors*, 92 Ill. Bar J. 263 (2004) (explaining that under Illinois law, “ABCs take less time than bankruptcy and require less in the way of court intervention and approval, which can mean lower professional fees for debtors.”).

¹⁷ Baird, Bris & Zhu, *supra* note 2, at Table 5.

¹⁸ Robert M. Lawless, et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. Ill. L. Rev. 847, 863 (1994).

¹⁹ Morrison, *Small Business*, *supra* note 1, at 79.

²⁰ Warren & Westbrook, *Success*, *supra* note 3, at 615.

²¹ NBRC Report, *supra* note 6, at 610.

²² Warren & Westbrook, *Success*, *supra* note 3, at 610-11. The IL Study found that about 17% of dismissals involved debtors that had undergone a going-concern sale or had hammered out an agreement

Most dismissals and conversions occur early in the case, pointing to quick decision-making by the judge. In the IL study, 70% of dismissals and conversions occurred within the first 6 months of the case; 44% occurred within three months.²³ That study also marshaled evidence showing that judges were adept in distinguishing viable and non-viable firms.²⁴ Consistent evidence is presented in the Multi-District study, which finds that the probability of confirmation was 47% among firms that avoided dismissal or conversion during the first 6 months. The probability rose to 67% among those that avoided those outcomes during the first 12 months. Judges “pushed the losers out early.”²⁵

Debtor in possession (DIP) financing appears uncommon. To our knowledge, the best available evidence is from a study of small business filings between 1986 and 1994 in the Northern District of Georgia.²⁶ That study found DIP financing (new loans or lines of credit that must be approved by the court) in 10 percent of Chapter 11s. The financing was rarely provided by a bank; 95 percent of loans were extended by suppliers with secured prepetition claims. On the other hand, the authors did not investigate the frequency and terms of cash collateral orders based on prepetition credit relationships, which can serve as a substitute for DIP loans and can subject debtors to the kinds of control often seen in DIP loans.

Small businesses make up the vast majority of Chapter 11 filings. The IL study found that 75 percent of debtors had debt under \$2 million and 77 percent had fewer than 20 employees.²⁷ Similar statistics are reported in the Multi-District Study. The NY/AZ Study found that, among confirmed Chapter 11s, median asset value was about \$1.2 million.²⁸ Likewise, the National Bankruptcy Review Commission surveyed 1995-97 data from six districts and found that that 72 percent of debtors had debt under \$2 million.²⁹

Many Chapter 11s involve businesses with little measurable value as a going concern relative to liquidation. Value as a going concern typically stems from specialized assets. The IL Study found that at most 5.5 percent of the median firm’s assets were specialized. Excluding restaurants, the percentage falls to 2.2. These percentages characterize firms with confirmed plans as well as those whose cases were dismissed or converted.³⁰

Chapter 11s can function as a “waiting period” for serial entrepreneurs as they consider their next ventures and resolve personal liability for business debts. The IL Study found that, among cases that were dismissed or converted, 70 percent of owner-managers went on to start

with key creditors. Morrison, *supra* note 4, at 390 tab. 4. Another 23% survived more than one year after the case was dismissed. *Id.*, at 291 tab. 5.

²³ Morrison, *Continuation Bias*, *supra* note 1, at 391.

²⁴ *Id.*, at 441.

²⁵ Warren & Westbrook, *Success*, *supra* note 3, at 621.

²⁶ Jocelyn Evans and Timothy Koch, *Surviving Chapter 11: Why Small Firms Prefer Supplier Financing*, 31 J. Econ. & Fin. 186, 191 (2007).

²⁷ These statistics were computed for this proposal.

²⁸ Bris, Welch & Zhu, *supra* note 2, at 1258.

²⁹ NATIONAL BANKR. REVIEW COMM’N, *BANKRUPTCY: THE NEXT TWENTY YEARS* 631 (1997) (Hereinafter “NBRC Report”).

³⁰ *Id.* at 2332.

new businesses or continued running other, non-bankrupt businesses. 85 percent of the owner-managers had founded a separate business in the past or went on to start another after the case was dismissed or converted.³¹ This may be unsurprising because entrepreneurs are highly unlikely to exit self-employment once they have owned businesses for several years.³²

Tax claims and personal guarantees are ubiquitous in small Chapter 11 cases. The IL Study, for example, found that the owner-manager was personally liable for business debts in 85 percent of the cases, due to personal guarantees (56 percent of cases) or liability for trust fund taxes (61 percent).³³ Another study surveyed owners of small businesses that filed for bankruptcy in the Central District of California (San Fernando Valley Division) during 2004 and 2005.³⁴ Thirteen percent of respondents stated that tax liabilities were a cause of their bankruptcy filings.

Unsecured creditors' committees are rarely formed in small Chapter 11 cases. The IL Study found unsecured creditors' committees in only 3% of cases in which business debts were less than \$2 million (2% in 1998, 6% in 2006).³⁵ The percentage rises to about 8% in cases reaching plan confirmation. By contrast, among firms with debt greater than \$2 million, a committee was formed in 33% of the cases. Another study reports similar statistics based on a quasi-random sample of cases throughout the United States.³⁶ It finds a committee in 19 percent of cases generally (median debt equal to \$1.2 million) and in 67 percent of cases involving large publicly-traded and privately-held firms (median debt equal to \$50.2 million). Similar statistics were reported by the National Bankruptcy Review Commission.³⁷

BAPCPA appears to have placed additional demands on the cash flow of Chapter 11 debtors. Sections 366(b), (c), and 503(b)(9) of the Bankruptcy Code now require the debtor to deposit cash sufficient to offer "adequate assurance" to utility suppliers and to give administrative expense priority to claims for goods supplied within 20 days of the bankruptcy petition. Although no empirical work has studied these sections yet, they likely impose larger burdens on small businesses than large firms because small businesses appear to face greater borrowing constraints.³⁸ Put differently, Sections 366(b) and 503(b)(9) increase the cost of

³¹ Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2337-40.

³² See, e.g., David S. Evans & Linda S. Leighton, *Some Empirical Aspects of Entrepreneurship*, 79 Am. Econ. Rev. 519 (1989) (studying 1966-81 data from the National Longitudinal Study of Youth and finding that the probability of exiting self-employment falls to zero after eleven years of owning a business).

³³ Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2362 tab. 17.

³⁴ Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, *supra* note 9, at 201.

³⁵ These statistics were computed for this proposal.

³⁶ Stephen Lubben, *Corporate Reorganization and Professional Fees*, 82 Am. Bankr. L. J. 77, 93-95 (2008).

³⁷ NBRC Report at 642.

³⁸ William M. Gentry & Glenn R. Hubbard, *Entrepreneurship and Household Saving*, 4 Adv. in Econ. Anal. & Policy, article 8 (2004), available at <http://www.bepress.com/bejeap/advances/vol4/iss1/art8>. But compare Erik Hurst & Annamaria Lusardi, *Liquidity Constraints, Household Wealth, and Entrepreneurship*, 112 J. Pol. Econ. 319 (2004) (doubting the importance of liquidity constraints for small businesses) with Robert W. Fairlie & Harry A. Krashinski, *Liquidity Constraints, Household Wealth, and*

Chapter 11 by forcing a small business to generate sufficient cash flow to cover these requirements immediately.

B. Fundamental problems in small business Chapter 11s

The foregoing statistical patterns suggest that when a small business attempts reorganization, these problems loom large:

- 1. Excessive Secured Creditor Influence.** Due to the small stakes for unsecured creditors, and the rarity of creditors' committees, secured creditors have excessive influence.
- 2. Monitoring Deficits.** Without active involvement from unsecured creditors, it can be difficult for a judge to assess whether the firm is a viable candidate for reorganization. The judge must rely heavily on the U.S. Trustee or bankruptcy administrator, but he or she is primarily concerned about the debtor's compliance with procedural requirements. Because around two-thirds of all cases end in dismissal or conversion, one of the judge's most important jobs is to "filter out" non-viable cases as quickly as possible. Although judges have developed tools for doing this, the success of these tools likely depends on the amount of time and effort that judges can devote to monitoring and supervising cases, something the 1978 Code discourages.³⁹
- 3. High Costs.** Administrative costs consume a significant percentage of firm value. These costs may deter distressed businesses, the majority of which use non-bankruptcy procedures (negotiation with creditors, assignments for the benefit of creditors, etc.) to resolve financial distress.
- 4. Obstacles to Reorganization.** BAPCPA's new requirements with respect to administrative expenses and adequate assurance effectively tax the cash flow of cash-strapped businesses, undermining chances for successful reorganization.

To be sure, the first three of these issues are not new. Monitoring Deficits and High Costs in particular were a concern of the National Bankruptcy Review Commission, which was created by Congress in 1994 to study the Bankruptcy Code.⁴⁰ With respect to the first issue, the Commission recommended, and BAPCPA adopted, various measures to give the U.S. Trustee greater power to monitor small business cases and to increase the information available to the court and Trustee. For example, the U.S. Trustee is now instructed to investigate the debtor's viability at the outset of the case,⁴¹ and the debtor is instructed to submit periodic financial

Entrepreneurship Revisited, (IZA Discussion Paper No. 2201 2006), available at <http://ssrn.com/abstract=920640> (challenging the work of Hurst & Lusardi).

³⁹ See, e.g., Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 Am. Bankr. L.J. 431, 4333-35 (1995); Dennis S. Meir & Theodore Brown, Jr., *Representing Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 217, 217 (1982).

⁴⁰ The commission's history is discussed at this website:
<http://govinfo.library.unt.edu/nbrc/facts.html>.

⁴¹ 28 U.S.C. § 586(a)(7).

reports and schedules, attend all meetings, timely pay taxes, and maintain insurance.⁴² Although BAPCPA extended the exclusivity period (from 100 to 180 days⁴³) and deadline for submitting a plan (from 160 days to 300 days⁴⁴)—contrary to the Commission’s recommendation⁴⁵—the Act imposed a new 45-day deadline for achieving plan confirmation.⁴⁶ These changes increased the obligations on small businesses but did not necessarily create the conditions to facilitate reorganization. Furthermore, BAPCPA reduced judges’ discretion in determining whether to dismiss or convert chapter 11 cases even though the empirical research reviewed earlier suggests that courts had good track records of sorting viable and nonviable cases.⁴⁷

The National Bankruptcy Review Commission addressed High Costs to some extent by recommending that disclosure statements be simplified or eliminated in small business cases and that courts promulgate standardized disclosure statements and reorganization plans. The first recommendation found its way into BAPCPA,⁴⁸ and there are now Official Forms for small business plans and disclosure statements.⁴⁹ Although this was a useful step, it did not address the many other ways in which Chapter 11 produces considerable administrative costs in small business cases.

II. Chapter 12 is a solution to the problems facing small business reorganizations

A promising fix to the problems of reorganizing small businesses already exists in the Bankruptcy Code. That approach, chapter 12, was enacted in response to a small business problem not unlike the one we face today. During the early 1980’s (and still today), farms were small businesses, often owned by members of a single family. Farm product prices were falling because of technological advances, improved transportation and mechanization and the growth of corporate farms.⁵⁰ The value of farmland was falling, especially in the Midwest. The lenders to farmers were in crisis for many reasons, including an avalanche of failed or failing banks that reduced the availability of credit. Lending to small business farmers dried up. Farmers couldn’t put in crops and soon could not make their mortgage payments.

Many small farm businesses attempted to reorganize in Chapter 11 cases.⁵¹ These cases inevitably failed for several reasons.⁵² Small farmers often could not afford the cost of the

⁴² 11 U.S.C. §§ 308, 1116.

⁴³ § 1121(e)(1).

⁴⁴ § 1121(e)(2).

⁴⁵ NBRC Report, at 64-65.

⁴⁶ 11 U.S.C. § 1129(e).

⁴⁷ 11 U.S.C. § 1112(b).

⁴⁸ § 1125(f).

⁴⁹ See http://www.uscourts.gov/bkforms/bankruptcy_forms.html#official.

⁵⁰ This paragraph draws on the discussion in Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 484-86 (2005); Steven Shapiro, Note, *An Analysis of the Family Farmer Bankruptcy Act of 1986*, 15 Hofstra L. Rev. 353, 360-62 (1987).

⁵¹ Shapiro, *supra* note 50, at 364.

⁵² This paragraph draws from Hon. A. Thomas Small, *Chapter 12-The Family Farmer Bankruptcy Act of 1986*, 1987 Norton Ann. Surv. Bankr. L. 1.

process.⁵³ Farm lenders lacked flexibility to negotiate outcomes that would work for small farm reorganizations. Lenders secured by farmland were often undersecured (that is, their debt exceeded the value of the property) and could vote the unsecured portion of their claims to defeat confirmation of any plan. Farmers in Chapter 11 could not sell part of their farms to reduce the operation to a size that was viable without the consent of their lenders.⁵⁴ Chapter 13 was rarely a useful alternative because the debt limits were too low,⁵⁵ only individuals were eligible⁵⁶ and the tools for management of secured debt were not robust enough to help farmers.⁵⁷

At the urging of Senator Grassley (R. Iowa) and the late Congressman Mike Synar (D. Okla.), Chapter 12 of the Bankruptcy Code was hatched to address the reorganization needs of farm businesses. The instructions from Synar and Grassley were simple: draft a new reorganization chapter accessible for farm businesses up to a certain size with ownership limited to the members of an extended family without the disclosure, voting and other complications of Chapter 11. The basic rights of creditors in a Chapter 11 case must be retained. Unsecured creditors must be paid at least what they would receive in a liquidation of assets under Chapter 7. Secured creditors must receive surrender of their collateral or the debtor must pay the “present value” of that collateral (meaning, with interest) through the plan. In recognition of the long-term nature of loans secured by farmland and equipment, farm businesses must be able to pay secured creditors (with interest) over an appropriate period of years. Legislation creating Chapter 12—The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986⁵⁸—was signed into law by President Reagan on October 27, 1986. The law became effective November 26, 1986.⁵⁹

⁵³ H.R. Conf. Rep. 99-958 at 5249, 1986 USCCAN 5246 (Oct. 2, 1986) (“Most family farmers have too much debt to qualify as debtors under Chapter 13 and are thus limited to relief under Chapter 11. Unfortunately, many family farmers have found Chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive and, in too many cases, unworkable.”).

⁵⁴ *Id.* (“Most family farm reorganizations, to be successful, will involve the sale of unnecessary property. [Section 1206] . . . allows Chapter 12 debtors to scale down the size of their farming operations by selling unnecessary property. This section modifies 11 USC 363(f) to allow family farmers to sell assets not needed for the reorganization prior to confirmation . . . the creditor's interest . . . would attach to the proceeds of the sale.”).

⁵⁵ See 11 U.S.C. § 109(e) (secured and unsecured debt limitations for Chapter 13). See also Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 486 (2005) (“debt limits allowed under Chapter 13 were too low for most family farmers”).

⁵⁶ § 109(e) (“Only an individual with regular income . . . may be a debtor under chapter 13 of this title.”). “Individual with regular income” is defined in § 101(30) to mean “an individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title[.]”

⁵⁷ In Chapter 13, farmers could not modify real estate secured loans and were limited in ability to sell property. See, e.g., § 1322(b)(2).

⁵⁸ Pub. L. No. 99-544, 100 Stat. 3105 (1986).

⁵⁹ Pub. L. No. 99-544, § 302(a).

A. Comparing Chapters 11 and 12

Table 1 sets out key differences between small business reorganization under Chapters 11 and 12. Perhaps the most important differences involve the appointment of a standing trustee, tighter deadline for submitting a plan of reorganization, lower repayment obligations, and more flexible treatment of administrative expenses in Chapter 12.

Although the debtor remains in control of his or her business regardless of the Chapter, only Chapter 12 mandates the appointment of a standing trustee in every case.⁶⁰ The trustee is charged with responsibility to monitor the case and to be heard at any hearing involving the valuation or sale of assets or the confirmation or modification of a plan.⁶¹ The standing trustee ensures that the court receives an unbiased, continuous flow of information about the firm's viability.

Chapter 12 also imposes stricter deadlines on the submission of plan of reorganization: a plan must be submitted within 90 days⁶² and either confirmed or rejected no more than 45 days later.⁶³ This contrasts with the much longer deadlines (300 days for plan submission) under Chapter 11's small business provisions.⁶⁴ The strict deadlines in Chapter 12 prevent firms from using the Code solely as a means for thwarting creditor collection efforts.

In Chapter 12, family farmers and fishermen can retain ownership interests in their businesses even if they cannot pay creditors in full. This outcome is prohibited by Chapter 11's absolute priority rule, but permitted under Chapter 12 because unsecured creditors are instead entitled to all of a Chapter 12 debtor's disposable income for up to five years⁶⁵ following plan confirmation and must receive at least what they would be paid in a Chapter 7 liquidation.⁶⁶ At the end of the repayment period, any unpaid unsecured claims are discharged. (Secured claims must be repaid in full, but payments can exceed the five year period of the Chapter 12 plan⁶⁷). These repayment rules ensure that a family farmer or fisherman does not engage in wasteful efforts to avoid bankruptcy for fear of losing ownership of the business. As long as secured creditors are repaid in full and unsecured creditors receive all of the business's disposable income for up to five years, the farmer or fisherman can retain ownership.

Finally, Chapter 12 offers debtors greater flexibility in repaying administrative expenses, such as attorney fees and the claims of suppliers who delivered goods within 20 days prior to the bankruptcy petition.⁶⁸ Chapter 11 requires immediate payment in cash on the date of confirmation (unless the claimants agree to different treatment).⁶⁹ Because family farmers and

⁶⁰ 11 U.S.C. § 1202.

⁶¹ § 1202(b).

⁶² § 1221.

⁶³ § 1224.

⁶⁴ §§ 1121(e)(2) (300 day deadline for submitting plan), 1129(e) (45 day deadline for confirmation hearing).

⁶⁵ §§ 1222(c), 1225(b).

⁶⁶ § 1225(a)(4).

⁶⁷ § 1225(a)(5).

⁶⁸ § 1222(a)(2).

⁶⁹ § 1129(a)(9).

