AMERICAN BANKRUPTCY INSTITUTE

2019 Alexander L. Paskay Memorial Bankruptcy Seminar

Business Session

Business Bankruptcy Legal Update

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CONCURRENT SESSION

2019

ALEXANDER L. PASKAY MEMORIAL BANKRUPTCY SEMINAR

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Business Bankruptcy Legal Update

Moderator: U.S. Bankruptcy Judge Robert A. Mark (S.D. Fla.) Miami

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Chapter 22 Good Faith Requirement Litigation Update

There is no statutory prohibition preventing a reorganized debtor from filing a second petition for relief under Chapter 11. *See* 11 USC § 109(a & g). Nevertheless, there are statutory arguments against allowing a second chapter 11 case that attempts to restructure debts that were restructured previously in a prior confirmed plan, including the res judicata effect of a plan under 11 U.S.C. § 1141, and the fact that under 11 U.S.C. § 127(b), a corporate debtor may not modify a plan after the first plan has been substantially consummated. Therefore, a corporate debtor generally is prohibited from filing a second chapter 11 case which has the effect of modifying a substantially consummated plan confirmed in a prior case. *In re Sandia Resorts, Inc.*, 2016 WL 48992 at *6 (Bankr. D.N.M. Feb. 5, 2016); *Matter of Bouy, Hall & Howard, and Associates*, 208 B.R. 737, 743 (Bankr. S.D. Ga. 1995).

There are exceptions to the general rule, including where there has been an extraordinary and unforeseeable change in circumstances that affected the debtor's ability to perform its obligations under its confirmed plan. *Sandia* at *7 *citing In re Caviata Attached Homes, LLC*, 481 B.R. 34, 47 (9th Cir. BAP 2012). Although regular changed market conditions alone are not sufficiently changed circumstances to warrant a second filing, where a debtor experiences a "fundamental change in its market" and not the typical fluctuations of supply and demand, if unforeseeable, the change may represent sufficiently changed circumstances to warrant a second filing. *Bouy Hall*, 208 B.R. at 745. In *Buoy Hall*, the Court found that the second case was filed in good faith because of unforeseen changes in the debtor's motel business arising from the opening of a new airport terminal and the collapse of an airline that was operating out of the old terminal.

Courts have identified factors in analyzing whether a second chapter 11 can proceed, including the length of time between the first and second Chapter 11, whether creditors consent to the second Chapter 11 reorganization and the extent an objecting creditor's rights were modified in the first Chapter 11 and its proposed treatment proposed in the second Chapter 11 plan. *In re Sandia Resorts, Inc.*, 2016

WL 489992 (Bankr. D.N.M. 2016). However, at least one Court has recently ruled that Chapter 22 was not appropriate where there was a lack of payments to a secured creditor and the second case was filed only to obtain a release of a personal guarantor, and no evidence was presented to evidence how the release helps the Debtor's reorganization efforts. *In re JCP Properties, Ltd.*, 540 B.R. 596 (Bankr. S.D. TX. 2015).

How will Courts view natural disasters as a part of this analysis? Hurricanes in Florida are subject of current litigation. Other cases such as Planet Hollywood were able to successful argue that the dot.com bust was a reason for Chapter 11. Could general political climate issues reach to the level of "unforeseeable change in its market."

Recent Developments in Matters Seeking Recharacterizing of Debt to Equity

The Eleventh Circuit, among at least five other Circuit Courts, recognize the power of bankruptcy courts to recharacterize debt as equity. *Estes v. N&D Prop., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). In cases of shareholder loans, recharacterization is proper in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit. *First NLC Financial Services, LLC v. NLC Holding Corp. et al.*, *(In re First NLC Financial Services, LLC)*, 396 B.R. 562, 567 (Bankr. S.D. Fla. 2008) *citing In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001). Recharacterization prevents an equity investor from labeling its contribution as a loan and circumventing the Bankruptcy Code's priority system by guaranteeing itself a larger recovery and higher priority if the debtor files for bankruptcy. *Id.* At 567.[1]

In one example, on a motion to dismiss, Court ruled that a valid cause of action for recharacterization existed where allegations were made by the Plaintiff consisting of: (i) no documents to specify advance was a loan; (ii) no fixed maturity date or specific right to enforce repayment; (iii) source

[1] For list of factors under multi-factor test adopted by the Middle District of Florida, see *Cary v. Vega (In re Vega)*, 503 BR 144, 151 (Bankr. M.D. Fla. 2013).

of repayment was earnings; and (iv) "lender" participated in the management of the Debtor. *Carn v. Heesung Pmtech Corp.*, 579 B.R. 282 (M.D. Ala. 2017). At least one Court has recently ruled that the practical application is whether the transaction reflects "the characteristics of an arm's length negotiation." *In re Lenexa Hotels, L.P.*, 2018 WL 1115199 (Bankr. D. Kan. 2018) (loan from shareholder and manager of company would not be recharacterized based on factors including no change in his management, sufficient documentation, and even in the face that he was the 100% owner of the Debtor). Contrast with *In re Comprehensive Power, Inc.*, 578 B.R. 14 (Bankr. D. Mass. December 2017), where lender obtained management rights not previously afforded based on new loan and not obligated to make monthly interest payments.

Litigating Non-Residential Lease Termination and 365 Issues under State Law

Florida Bankruptcy Courts have held different views on the effect of a final judgment for possession or issuance of a writ of possession on the termination of a lease, notably with application of underlying Florida law. Judge Williamson has held that the mere issuance of a writ of possession, without more, does not preclude a debtor from assuming a lease under Section 365. *In re 2408 W. Kennedy, LLC*, 512 B.R. 708 (Bankr. M.D. Fla. 2014). Judge Williamson cites Judge Paskay's decision in two separate cases, which held that a debtor could assume a commercial lease because it had not been validly terminated prepetition even though the debtor's landlord had obtained both a judgment for possession and writ of possession. Judge Williamson reasoned the fact that a writ of possession's actual execution might extinguish the right to retain possession of the leased premises but did not further define "more". However, our very own Judge Mark has ruled that a judgment for eviction precludes a debtor from assuming a lease in bankruptcy because the eviction judgment terminates the debtor's right to possession. *In re Key Largo Watersports*, *Inc.*, 377 B.R. 738 (Bankr. S.D. Fla. 2007).

Judge Isicoff also weighed in on this legal debate. While Judge Isicoff agreed with Judge Williamson's analysis, generally, she went further and defined at what point during execution of the writ of possession the right of possession legally terminates, and what relevance, if any, does that have to the Debtor's rights under Section 365. *In re Petit USA, LLC*, 2016 WL 8504995 (Bankr. S.D. Fla. 2016). The Court held that the legal right of possession is not lost even if the Sheriff shows up to the premises with the writ and that loss of physical possession is not the same as termination of the lease.

Judge Isicoff essentially defined "more" in this context holding that debtor's loss of possession is not complete until the debtor has been physically dispossessed. Execution of a writ of possession in Florida is a process, and the process is not complete until the tenant is physically dispossessed of the property and possession is turned over to the landlord. Changing locks is not necessary but "more" could be met when debtor's representatives left the building. Contrast with *In re Marrero*, 2018 WL 5281626 (Bankr. D.P.R. 2018) where the Civil Code of Puerto Rico held that a month to month lease terminates without requiring any special request to do so every month, thus terminating the lease pre-petition.

MISSION PRODUCT HOLDINGS v. TEMPNOLOGY – What is the effect of rejection under Section 365(g)?

In October 2018, the United States Supreme Court granted cert with respect to the First Circuit's decision in *In re Tempnology, LLC*, 879 F.3d 389 (1st Cir. 2018) noting a circuit split between the Fourth Circuit's decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers Inc*., 756 F.2d 1043 (4th Cir. 1985) and the Seventh Circuit's decision in *Sunbeam Products, Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012).

In *Lubrizo*l, the court held that rejection of an executory license for intellectual property prohibited the non-debtor licensee from continuing to use the intellectual property. In response, Congress adopted Section 365(n) of the Bankruptcy Code. However, Section 365(n) does not include trademarks in the definition of intellectual property.

In 2012, the Seventh Circuit in *Sunbeam* ruled that rejection of a trademark license does not preclude continued use of the trademark. Judge Easterbrook noted that rejection does not "vaporize" the licensee's rights and that *Lubrizol* had been "uniformly criticized."

The First Circuit's opinion in *Tempnology* was a 2/1 split with the dissent following *Sunbeam*. The Supreme Court's cert order limited review to the question of whether rejection of a trademark license "terminates the rights of the licensee that would survive the licensor's breach under applicable nonbankruptcy law." The International Trademark Association filed an amicus brief supporting review and promoting the Seventh Circuit's view in *Sunbeam*.

Initially, commentators viewed this case as being limited to Section 365(n). But after the granting of cert, it is believed that this case has the potential to affect every rejection of every executory contract in a wide variety of contexts with a focus on Section 365(g). Section 365(g) is clear that rejection equals "breach" and not termination. The question presented in the petitioner/licensee's initial brief expressly references Section 365(g). The majority in *Tempnology* indicated that the argument rests on "an exploration of what rejection means."

The majority in *Tempnology* focused on the debtor's obligation to "monitor and exercise control over the quality of goods sold to the public under cover of the trademark." And noted that *Sunbeam* entirely ignores the "residual enforcement burden" on the rejecting debtor. In comparison, the dissent argued that that majority's view treats the debtor's rejection as a cancellation of the contract, rather than a breach.

A potential problem with the majority view is that it focuses on the purported harm to the breaching party rather than the obvious harm to the non-breaching party. In some respects, the alleged "burden" on the breaching debtor is arguably no burden at all, but something that the debtor will be doing anyway if it continues to benefit from the trademark. And no burden if the debtor simply abandons the trademark – something more consistent with rejection. If the debtor fails to monitor and enforce the trademark, that will be the non-debtor licensee's problem and certainly devalue what was licensed. But what was apparently going on in *Tempnology* is that the debtor wanted to license the trademark for more money. Is that the proper result of a rejection or breach by the debtor? Isn't the point of rejection to excuse the debtor from further performance under the executory contract, i.e. excuse the debtor from monitoring and enforcing the trademark? Or is the point of rejection to let the debtor recover valuable property rights from non-debtor licensees? Could rejection become a type of "avoidance" power?

Another potential problem with the majority view is the effect on other executory contracts in other contexts. For example, under the majority view is there an argument that a non-competition covenant is vaporized by rejection? A non-compete prohibits a debtor from making a living – an arguably much greater burden than monitoring a trademark. *See In re Andrews*, 80 F.3d 906 (4th Cir. 1996)(discussing *Lubrizol* in the context of a non-compete). What about an executory contract where the obligations are secured by a lien on the debtor's assets? Is the lien vaporized when the contract is rejected?

It will be interesting to see where the Supreme Court goes on this issue.

ABI 2018 seminar materials - Tempnology:5084535_1 ABI 2018 seminar materials - Tempnology:5084535_1

MERIT MANAGEMENT GROUP v. FTI CONSULTING – What's left of Section 546(e)?

On February 27, 2018, the United States Supreme Court held in *Merit Management Croup, LP v. FTI Consulting Inc*., ___ U.S. ___, 138 S.Ct. 883, 200 L.Ed.2d 183 (2018) that the securities safe harbor protection in Section 546(e) of the Bankruptcy Code does not protect "transfers in which financial institutions served as mere conduits." Section 546(e) provides a safe harbor or immunity from avoidance claims not based on actual fraud where a "settlement payment" or transfer "in connection with a securities contract" is "made by or to (or for the benefit of)" certain protected parties, including financial participants and financial institutions (defined terms in the Bankruptcy Code).

The Supreme Court affirmed the Seventh Circuit, followed the Eleventh Circuit's decision in *In re Munford*, 98 F.3d 604 (11th Cir. 1996), and abrogated decisions from the Second, Third, Sixth, Eighth and Tenth Circuits, rejecting the application of the 546(e) immunity where the financial institution was an intermediary. The focus of the Supreme Court's ultimate conclusion was - what is the "relevant transfer" for purposes of Section 546(e)? The petitioner had argued that the Court should focus on all of the component parts of the transfer from the debtor to Merit, including the financial intermediary. The Court focused on the "overarching transfer" from the debtor to Merit – the transfer that the trustee sought to avoid.

In *Merit*, as noted by the Seventh Circuit in the underlying appellate decisions, neither the transferor nor the transferee was a typical party in the securities industry, but simply private corporations that wanted to exchange money for privately owned stock – stock in a "racino," a racetrack/casino. The parties teed up the very narrow "conduit" issue before the Supreme Court and the Court provided a fairly narrow answer. What's more important about *Merit* is not what the Court decided, but what the Court didn't decide.

First, the parties did not ask the Supreme Court to determine whether the transaction at issue qualified as a "settlement payment" or a transfer made in connection with a "securities contract" and the Court did not make that determination. The terms "settlement payment" and "security" are defined in Section 101 of the Bankruptcy Code. While the definition of "settlement payment" in 101(51A) is somewhat narrow, the definition of "security" in 101(49) is very broad, including a simple promissory note. Given that the transaction in *Merit* was an isolated transaction between two private parties, the case could have been decided on this issue.

Second, the parties did not contend that either the debtor or the transferee qualified as a "financial institution" by virtue of its status as a "customer" under Section 101(22A) of the Bankruptcy Code, and the Supreme Court did not address the impact, if any, such definition would have in the application of Section 546(e). Section 101(22A) defines "financial institution" to include a "customer" of a "financial institution" where the institution is acting "as agent or custodian." In other words, if the debtor or Merit were a customer of a bank acting as a custodian, then the debtor or Merit was a protected entity that the subject transfer was made "by or to." This issue was raised at oral argument and certainly could have dictated the outcome of the case. This is an important practice point for how to structure a transaction – with a custodial bank involved – so that the safe harbor applies. Some of the feeder funds in the Petters case in Minnesota utilized a custodial bank and the issue has been raised in at least one adversary against a subsequent transferee, but no decision has been made.

Since the decision last February, a keycite of the *Merit* decision shows less than 20 cites. Only three cases substantively discuss *Merit* – all opinions from Bankruptcy Judge Bernstein in the Southern District of New York. None of the cases discuss the actual impact of *Merit*. In the most recent case, *In re Fairfield Sentry Limited*, 2018 WL 6431741 (Bankr. S.D.N.Y. December 6, 2018), the court denied motions without prejudice because the parties' submissions predated the Supreme Court's opinion. We are yet to see the true impact, if any, of the *Merit* decision.

The decision in *Fairfield Sentry* was remarkable on a related point – will the avoiding powers and the safe harbor be given extraterritorial effect? *Fairfield Sentry* is a chapter 15 proceeding where the foreign BVI liquidator of a Madoff feeder fund is seeking recoveries against investors. In a decision that is arguably at odds with Supreme Court precedent and a District Court decision in Madoff, Judge Bernstein ruled that the safe harbor can apply extraterritorially. The District Court decision is currently on appeal to the Second Circuit. *In re Picard*, 17-2992 (2d Cir.). In any event, Judge Bernstein has requested further briefing on whether any of the parties was a "financial participant" – one of the covered entities under Section 546(e) and a relatively complicated defined term in the Bankruptcy Code.

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Subsequent New Value Need Not Remain Unpaid

Kaye v. Blue Bell Creameries, Inc., 889 F.3d 1178 (11th Cir. 2018)

Under 11 U.S.C. § 547(c)(4), transfers cannot be avoided as preferences to the extent that, after the transfer, the transferee provided "new value":

> (c) The trustee may not avoid under this section a transfer—
>
> * * *
>
> (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
>
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

In summarizing the elements of this defense, some courts, including the Eleventh Circuit, have stated that Section 547(c)(4)(B) requires that the subsequent new value must have remained unpaid as of the petition date. *See Charisma Investment Company, N.V. v. Airport Systems, Inc. (In re Jet Florida System, Inc.)*, 841 F.2d 1082 (11th Cir. 1988). The Eleventh Circuit recently clarified this element in *Kaye v. Blue Bell Creameries, Inc. (In re BFW Liquidation, LLC*, 889 F.3d 1178 (11th Cir. 2018).

First, the Court concluded that its statement in *Jet Florida* that subsequent new value must remain unpaid was dictum and was therefore not binding. Examining the plain language of the statute, the Court held that, by its terms, Section 547(c)(4)(B) only excludes new value which was paid with an "otherwise unavoidable transfer." Thus, subsequent new value paid with a transfer which itself is avoidable provides a defense under Section 547(c)(4).

Because Section 547(c) is not ambiguous, the Court was not required to look beyond the language of the statute. It noted, however, that its reading is consistent with the statutory history and promotes the purpose of Section 547(c) by encouraging creditors to continue extending credit to financially troubled debtors.

The Court further rejected the Trustee's argument that "otherwise" in Section 547(c)(4)(B) means that only subsequent new value which was paid with a transfer which is avoidable *under a section other than under Section 547*, *i.e.*, under Section 548, comes within this defense. The Court reasoned that this interpretation would not only illogically narrow the subsequent new value defense but was inconsistent with the Court's reading of the statute. It held that "otherwise" refers to other subsections of Section 547(c), so that new value paid with a transfer which is rendered unavoidable by another Section 547(c) defense, such as ordinary course, would be excluded from Section 547(c)(4).

Good News Update on Attorney's Fees

Wilmington Trust Co. v. Tribune Media Co. (In re Tribune Media Co.),
2018 WL 6167504 (D. Del. November 26, 2018)

In a recent appeal from the Tribune bankruptcy case, the District of Delaware reversed an order by the bankruptcy court disallowing an unsecured claim for contractual post-petition attorneys' fees. Its conclusion required interpreting Sections 502 and 506(b) of the Bankruptcy Code.

Under Section 502(a), a claim is allowed unless a party in interest objects. When an objection is filed, Section 502(b) requires the bankruptcy court to determine the amount of the claim and allow the claim, subject to certain exceptions. The exceptions include that the claim is unenforceable under any applicable law, including the Bankruptcy Code.

Section 506(b) expressly allows post-petition attorneys' fees on oversecured claims. The Debtor argued that, under the *expressio unius est exclusio alterius* (express mention of one thing excludes all others) canon of statutory construction, Section 506(b) implicitly disallows unsecured claims for contractual post-petition attorneys' fees.

The Supreme Court, however, has held that claims which are enforceable under state law are allowed under Section 502 unless they are expressly disallowed in the Bankruptcy Code. *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 452-54 (2007). And every Circuit court which has considered the issue post-*Travelers* has rejected the Section 506(b) argument and has allowed unsecured claims for contractual post-petition attorneys' fees.[1] Reasoning that it could not conclude that Section 506(b) expressly disallows unsecured claims for contractual post-petition attorneys' fees, the District Court agreed with these cases.

Armstrong Bank v. Shraiberg, Landau & Page, P.A.
(In re Tuscany Energy, LLC, 581 B.R. 681 (Bankr. S.D. Fla. 2018)

In *Tuscany Energy*, the bankruptcy court dismissed an adversary proceeding by a creditor asserting a security interest in funds paid to debtor's counsel as a prepetition retainer and requesting an order requiring the return of the retainer to the estate. The court's decision was largely based upon its conclusion that, under U.C.C. Section 9-332, even if the creditor had had a perfected security interest in the funds used to pay the retainer, it lost its security interest when the funds were transferred to debtor's counsel.

Under Section 9-332, a transferee of funds from a deposit account takes free of any security interest "unless the transferee acts in collusion with the debtor in violating the rights of the secured party." As the bankruptcy court explained, because the UCC favors the finality of payments, Section 9-332 is intended to severely limit the ability to pursue transferees. Its exception for "collusion" therefore excludes only "bad actors," who "affirmatively engaged in wrongful conduct."

The creditor alleged that debtor's counsel acted inequitably because it was aware that the creditor had a lien on all the debtor's assets, including deposit accounts, and knew that the debtor was in default, but nevertheless sought and received the retainer. The bankruptcy court held that these facts were insufficient to support a claim for collusion.

As a result, the creditor could not show that it had a perfected security interest in the retainer funds as of the petition date and could not support its claims. The court further held the claims should be dismissed because the UCC impliedly prohibits claims requiring lesser proof than the collusion standard of Section 9-332, as permitting the pursuit of such claims would undermine the purpose of the statute.

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[1] Including the 7th, 2d and 9th Circuits. Interestingly, the District Court cited to *Welzel v. Advocate Realty Invs., LLC (In re Welzel),* 275 F.3d 1308 (11th Cir.2001) as allowing an unsecured claim for contractual post-petition attorneys' fees even before *Travelers*, but this reference appears to be to dictum.

1. Rejection of Contact Issues:

(a) ***In re Herrera-Edwards*, 2018 WL 3752137, _____ Fed. Appx. _____ (Case No. 17-15353, 11th Cir. Aug 7, 2018).**

The Eleventh Circuit issued an opinion in August 2018 confirming that a debtor cannot obtain broader rights than the debtor initially had by seeking to reject an executory contract. Though a seemingly simple concept, the case involved complex issues of copyright law. However, in the end, it is important for debtor's counsel to consider the scope of the debtor's rights before considering whether rejection will have the intended effect.

The debtor, Ms. Herrera-Edwards, obtained an interest in music copyrights through a settlement with the estate of her deceased husband in 1997. Under the settlement, her husband's estate agreed to allocate the ownership and income from the decedent's copyrights among his former wife, his six children with the former wife, and Ms. Herrera-Edwards. Furthermore, the settlement provided that such parties would enter into a co-publishing agreement governing, among other things, the administration of the copyrights. Under copyright law, the administration rights govern how the copyrights can be exploited through negotiating licenses for use of the copyrighted works and handling the income received therefrom.

Under the settlement agreement and co-publishing agreement, Ms. Herrera-Edwards received significant royalties for many years. However, in 2012, she filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. In her bankruptcy case, the debtor requested that the bankruptcy court reject the executory portions of the co-publishing agreement. Through rejection of the co-publishing agreement, the debtor hoped to obtain the administration rights in her portion of the copyright interests in order to receive either an advance or loan against her copyright interests to satisfy the claims of creditors in her Chapter 11 case.

The debtor's rejection argument relied heavily on the Eleventh Circuit's prior recognition that rejection should be considered under the "functional approach" as opposed to the "Countryman" approach adopted by other circuits. While the "Countryman" approach requires that there exist material unperformed obligations on both sides of the contract, under the Eleventh Circuit's functional approach, "the question of whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate." *In re Gen. Dev. Corp.*, 84 F.3d 1364, 1366 (11th Cir. 1996). Thus, a contract may be executory under the functional approach where there are material obligations outstanding as to one of the parties to the contract, if the assumption or rejection would ultimately benefit the estate. *See Horizons A Far, LLC v. Webber (In re Soderstrom)*, 484 B.R. 874, 879 (M.D. Fla. 2013). Essentially, the debtor argued that, to the extent that the co-publishing agreement first granted the debtor an interest in the copyrights and then, subsequently, delegated the administration rights back to the decedent's estate, via rejection she could administer her own copyright interest without relying on the decedent's estate (or its successor-in-interest) to administer her copyright interest.

The bankruptcy court held a six-day trial on the issues raised in the rejection motion, together with certain other claims for declaratory and affirmative relief in a related adversary proceeding, at the conclusion of which the bankruptcy court denied the debtor's motion to reject the co-publishing agreement. Specifically, the bankruptcy court found that neither the original settlement agreement nor the co-publishing agreement gave the debtor any administration rights in her copyright interests and, rejection of the co-publishing agreement could not revest in the debtor any rights she did not originally have. The bankruptcy court relied upon the Eleventh Circuit's decision in *Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306-08 (11th Cir. 2007) for the rule of law that "rejection does not allow the bankruptcy court to divest a right that has already vested in another party to the agreement or to undo performance that has already occurred." *Id.* at 6. The district court affirmed the bankruptcy court's ruling on essentially the same grounds.

On appeal to the Eleventh Circuit, the debtor argued that the bankruptcy court erred by finding she never had administration rights in her copyright interests because, as a matter of law, ownership of a copyright includes the right to administer the copyright. *Id.* at 8 (citing 17 U.S.C. § 106 for the rights granted to copyright owners by statute). However, the Eleventh Circuit reasoned that copyright law permits the transfer of copyrights "in whole or in part" and, under the settlement agreement and co-publishing agreement, the administration rights were severed from the copyrights and never transferred to the debtor. Thus, the Eleventh Circuit concluded that the administration rights were retained by her husband's estate and eventually transferred to trusts for his children, and that a motion to reject cannot undo the vested transfer of the administration rights, citing *Lil' Joe Records, Inc.* case above. *Id.* at 9. As such, the Eleventh Circuit affirmed the district court's decision affirming the bankruptcy court denying the debtor's motion to reject.

(b) *In re Revel AC, Inc.,* 909 F.3d 597 (3rd Cir. 2018).

In this recent Third Circuit opinion, the court found that, notwithstanding the acquisition of a debtor-landlord's property "free and clear" of liens, claims, and encumbrances under § 363(f), the tenant was permitted to reduce its future rent obligations to the purchaser by the amounts due from the debtor under § 365(h) and the common law doctrine of equitable recoupment.

After the failure of the Revel resort and casino in Atlantic City, New Jersey, the initial owner of the property, Revel AC, Inc., filed a voluntary Chapter 11 petition in 2014. In 2015, the debtor sold its assets to Polo North Country Club, Inc. ("Polo") "free and clear" of all liabilities under § 363(f). Such assets included certain claims for rent that the debtor held against IDEA Boardwalk, LLC ("IDEA"), the tenant of two nightclubs and a beach club on the premises. However, the sale order also specifically preserved (i) certain "rights (including rights of setoff and recoupment), claims and defenses of IDEA" asserted in an adversary proceeding against the debtor and (ii) "any rights elected to be retained by [IDEA] pursuant to section 365(h) of the Bankruptcy Code."

Under a complex lease, IDEA paid "rent" to the debtor but was entitled to receive certain "recoupment" payments from the debtor that would only result in rent due to the debtor only if IDEA was profitable during the initial four-year term of the lease. *Id.* at 9.

After entry of the sale order in 2015, the bankruptcy court granted the debtor's motion to reject IDEA's lease retroactively to September 2, 2014, when the debtor stopped operating, which resulted in Polo not having to perform as landlord under the lease. In response to the rejection of the lease and as permitted in the sale order, IDEA filed a notice of election under § 365(h) to retain its rights as a tenant under the rejected lease. As a result of the sale order, rejection, and § 365(h) election, IDEA and Polo continued to litigate in the bankruptcy court over the amount of rent due from IDEA to Polo and the recoupment and other offsets permitted to IDEA under § 365(h).

On summary judgment, the bankruptcy court ruled that IDEA was permitted to (1) offset against future rents payable to Polo any damages caused post-acquisition by Polo's nonperformance under the lease, and (2) reduce its rent obligations to Polo by both the *pre-* and *post*-acquisition recoupment payments due to IDEA under the lease. *Id.* at 5. The bankruptcy court's reasoning was that the recoupment provisions of the lease were within the rights preserved under § 365(h)(1)(A)(ii), which provides that:

> [i]f the trustee rejects an unexpired lease of real property under which the debtor is the lessor. . . [and] if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease . . . .

Id. at 8 (citing § 365(h)(1)(A)(ii)). The bankruptcy court further reasoned that the IDEA could deduct the recoupment amounts due under the lease from the rents payable to Polo under the equitable doctrine of recoupment. *Id.* Polo appealed to the district court, which affirmed the bankruptcy court on the same reasoning as the bankruptcy court. *Id.*

Polo then appealed to the Third Circuit, which reviewed the legal issues *de novo*. *Id.* at 7. In analyzing the rights IDEA retained under § 365(h)(1)(A)(ii), the circuit court found that such election permits a tenant to "remain under the same rental terms as are set forth in the lease." *Id.* at 9 (citing *Megafoods Stores, Inc. v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.)*, 60 F.3d 1031, 1034 (3d Cir. 1995) (quoting *In re TM Carlton House Partners*, 97 B.R. 819, 823 (Bankr. E.D. Pa. 1989)). The circuit court further reasoned that, although the rent and recoupment obligations are distinctly set forth in the lease, they operated in an inextricably related manner to determine IDEA's rental obligations under the lease. *Id.* at 9. Thus, separating the rent and recoupment components post-acquisition would "upend the rent framework established in the Lease and deny IDEA's statutory right to remain in possession of the premises under the same 'rental terms.'" *Id.* at 10. As such, the Third Circuit affirmed the ruling that IDEA could setoff post-acquisition recoupment rights under the lease against post-acquisition rents due to Polo under the lease under § 365(h) of the Bankruptcy Code. *Id.*

The Third Circuit likewise affirmed that IDEA was permitted to reduce its rental obligations to Polo by either the *pre-* or *post*-acquisition recoupment amounts due to IDEA pursuant to the lease under the doctrine of equitable recoupment. Relying on its own prior decisions, the Third Circuit reasoned that, even though the doctrine of equitable recoupment is not in the Bankruptcy Code, the holder of equitable recoupment claims against a debtor "avoids the usual bankruptcy channels" and "receives full value in the netting of obligations . . . without regard to the bankruptcy priority of the claim." *Id.* at 10-11. To qualify for such treatment, the recoupment claim must arise from the same transaction as the debtor's claim against the holder of such recoupment claim. The court made clear that the mere identification of the parties and similar subject matter is not sufficient to trigger equitable recoupment but, "[r]ather, both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *Id.* at 11 (quoting *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992)).

The Third Circuit further reasoned that the "free and clear" nature of the sale to Polo would not restrict IDEA's equitable recoupment claims because (i) IDEA's rights, claims, and defenses were preserved by the sale order, and (ii) even if they were not so preserved, "the doctrine of equitable recoupment is an affirmative defense, and the sale of assets 'free and clear' of liens, encumbrances, and interests 'does not include defenses to claims.'" *Id.*at 12 (citing *Folger Adam Sec., Inv. V. DeMattis/MacGregor, JV*, 209 F.3d 252, 258-64 (3d Cir. 2000)).

Thus, when representing a buyer in an acquisition of tenant-occupied property "free and clear" under 363(f), it is still important to consider the import of both the rights of the tenant(s) under 365(h) and any potential "equitable recoupment" claims such tenant(s) may have against the debtor lest the buyer not receive the expected pre- and post-acquisition rents it may have otherwise been expecting.

2. Update on Nonconsensual Third-Party Plan Releases: *In re Millennium Lab Holdings II, LLC*, 591 B.R. 559 (D. Del. 2018).

During last year's program, the Business Bankruptcy Legal Update panel addressed the recent developments in the area of the authority of bankruptcy courts to approve nonconsensual third-party releases as part of the confirmation of plans of reorganization in Chapter 11 business cases. One of the recent cases discussed in detail both at last year's program and in the materials was *In re Millennium Lab Holdings, LLC*, 575 B.R. 252 (Bankr. D. Del. 2017), in which Bankruptcy Judge Laurie Selber Silverstein held that the bankruptcy courts have constitutional authority to enter final orders granting nonconsensual third-party releases as part of the Chapter 11 plan confirmation process. This past September, on appeal, the district court affirmed the ruling of the bankruptcy court that it had constitutional and subject-matter jurisdiction to enter such nonconsensual third-party releases and doing so was not in violation of the Supreme Court's ruling in *Stern v. Marhsall*, 131 S.Ct. 2594, 2603 (2011). Alternatively, the district court also ruled that the appeal of the confirmation order was equitably moot as a result of the substantial consummation of the confirmed plan and the inability of the district court to grant any effective relief on appeal.

In December 2015, Bankruptcy Judge Silverstein confirmed the pre-packaged plan of Millennium Lab Holdings, LLC and certain affiliated debtors, which provided for certain non-debtor equity holders to contribute $325 million toward the restructuring of the debtors and, in exchange, they would receive broad nonconsensual third-party releases from RICO and common law fraud claims asserted by the debtors' senior secured lenders arising from the equity holders' receipt of $1.3 billion in special dividends from the debtors prior to the Chapter 11. In the bankruptcy court's bench ruling overruling the lenders' objections and confirming the debtors' plan with the releases, Judge Silverstein held that she had "related to" jurisdiction over the RICO and fraud claims inasmuch as the equity holders were entitled to be indemnified by the debtors with respect to such claims. However, Judge Silverstein did not fully address the constitutional jurisdiction of the bankruptcy court to enter such releases.

The senior lenders appealed the confirmation order arguing, among other things, that the bankruptcy court lacked constitutional jurisdiction to enter the releases under *Stern*. Because the lenders failed to obtain a stay of the confirmation order pending appeal, the debtors argued that the appeal was equitably moot. On appeal, without ruling on the debtors' motion to dismiss the appeal, the district court remanded the case to the bankruptcy court for further consideration or clarification on whether the bankruptcy court had constitutional jurisdiction to enter a final order on the nonconsensual third-party releases.

On remand, Judge Silverstein rejected the lenders' broad interpretation of *Stern* as precluding the bankruptcy courts from entering final judgments on "all state court claims, all common law causes of action or all causes of action under state law." *See Millennium*, 575 B.R. at 268-69. Rather, the bankruptcy court held that, under the narrow interpretation of *Stern*, "a bankruptcy court lacks constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." *Id.* at 266-67. Judge Silverstein reasoned that the operative proceeding before the court was not the state court claims the lenders asserted against the nondebtor equity holders but, rather, confirmation of the debtors' plan, which is at the core of the bankruptcy courts' jurisdiction. *Id.* at 271-72.

On appeal back to the district court, Judge Leonard P. Stark affirmed Judge Silverstein's decision. *In re Millennium Lab Holdings II, LLC*, _____ F.3d _____ (Case No. 17-1461 D. Del. Sept. 21, 2018). Importantly, in this second decision, the district court retreated from statements in its earlier opinion remanding the case that approval of the plan releases was "tantamount to adjudication of [the lender's state law] claims on their merits." *Id.* at 20. Adopting the bankruptcy court's narrow reading of *Stern*, the district court concluded that plan confirmation was the operative proceeding before the bankruptcy court, not the merits of the lenders' state law claims, and that the bankruptcy court had constitutional authority to enter a final order on confirmation of the plan even if it included nonconsensual third-party releases. The district court further concluded that the bankruptcy court "determined only that the bankruptcy-specific standards for approving nonconsensual releases in a plan were satisfied" and, while such ruling may have impacted the lenders' state law claims, it did not "adjudicate the merits of those claims." *Id.* at 14. Because the district court concluded that the bankruptcy court had constitutional jurisdiction to enter a final order on the plan releases, the district court did not decide whether the lender had waived the *Stern* question by not raising it prior to confirmation of the plan.

As such, until the Third Circuit or Supreme Court address directly the constitutional authority of bankruptcy courts to approve nonconsensual third-party releases as part of the confirmation of a debtor's Chapter 11 plan, it appears that the "narrow" interpretation of *Stern* will not prevent bankruptcy courts in the Third Circuit from entering final orders granting nonconsensual third-party releases as part of the plan confirmation process.

3. Summary of the proposed Small Business Reorganization Act of 2018 and comparison to the Final Report of the ABI Commission to Study the Reform of Chapter 11.

In 2014, the ABI Commission to Study the Reform of Chapter 11 (the "Commission") issued its Final Report and Recommendations (the "Final Report"), a complete copy of which is available at http://commission.abi.org/. Among the many recommendations of the Commission, the Final Report included numerous recommendations for reforming and streamlining Chapter 11 cases for small and medium-sized businesses. For ease of reference, we have included in these materials a copy of Part VII of the Final Report setting for the Commission's proposed recommendations for small and medium-sized enterprise cases.

Recently, Senate Judiciary Committee Chairman Chuck Grassley introduced the *Small Business Reorganization Act* ("SBRA") to "streamline existing bankruptcy procedures and provide new tools to increase a small business' ability to achieve a successful restructuring." *See* Nov. 29, 2018 press release at https://www.grassley.senate.gov/news/news-releases/grassley-bipartisan-colleagues-introduce-legislation-help-small-businesses. We have included in these materials a copy of the SBRA introduced in the Senate by Sen. Grassley.

The SBRA proposes the creation of a new Subchapter V of Chapter 11 governing "Small Business Debtor Reorganization," which, among others, will include following major changes to how Chapter 11 cases are administered for small business debtors:

- Small business case would be the default for small business debtors: Under the SBRA, small business debtor cases would be governed by new Subchapter V of Chapter 11 by default unless the debtor elects not to be under Subchapter V. *See* SBRA § 4(a)(1)(A).

  - The default application of separate rules for small business cases generally conforms to the recommendations of the Commission in the Final Report.

- Definition of small business debtor: Currently, section 101(51D) of the Bankruptcy Code generally defines a "small business debtor" as a debtor engaged in business activities (other than a single asset real estate debtor) having aggregate noncontingent liquidated secured and unsecured debts not more than $2,566,050 for which the United States trustee had not appointed a committee of unsecured creditors. Under the SBRA, the definition of a small business debtor would add the requirement that 50 percent or more of the debts arise from the commercial or business activities of the debtor and exclude any public companies subject to SEC reporting requirements. *See* SBRA § 4(a)(1)(B).

  - The Final Report recommended that debtors with assets or liabilities less than $50 million be permitted to request applications of the small business case rules; however, the SBRA does not appear to permit an "opt in" to Subchapter V for debtors that otherwise exceed the debt limitations for a small business debtor.

- Elimination of creditor's committees: The SBRA provides that a committee of creditors may not be appointed under Section 1102(a) of the Bankruptcy Code "[u]nless the court for cause orders otherwise." *See* SBRA § 4(a)(11).

- This does appear to generally conform to the Commission's recommendation in the Final Report that unsecured creditors' committee not be appointed in small business cases absent court approval.

• Automatic appointment of a trustee in small business chapter 11 cases: The SBRA proposes a new section 1183 of the Bankruptcy Code, which would provide for the automatic appointment of a trustee in small business Chapter 11 cases to perform the duties under sections 704(a)(2) [accountable for all property received], (5) [examine and object to proofs of claim], (6) [oppose the discharge is advisable], (7) furnish information regarding the estate administration to parties in interest, and (9) [provide a final report and accounting to the United States Trustee]. *See* SBRA § 2. Under new section 1183 proposed by the SBRA, among other things, the chapter 11 trustee would also be heard at any status conferences or any hearings regarding valuation, confirmation, plan modification, or sale of property of the estate and, would have specific authority to "facilitate the development of a consensual plan of reorganization. *See id*. Generally, the trustee's services would terminate upon substantial consummation of a confirmed plan under new section 1183(c). *See id*.

In addition, new section 1183(b)(2) would permit the court, for cause, to direct that the trustee also perform the duties under sections 1106(a)(3) [investigate the acts, conduct, assets, liabilities, and financial affairs of the debtor], (4) [file a statement of any investigation under (3)], and (7) [file post-confirmation reports]. *See id*. Also, under new section 1185, the court may remove the debtor as debtor in possession for cause, including fraud, dishonesty, incompetence, gross mismanagement of the affairs of the debtor, or the failure to perform the obligations under a confirmed plan, in which case the Chapter 11 trustee would take over. *See id*.

- The Commission did not recommend the automatic appointment of a Chapter 11 trustee in small business cases but, rather, the Final Report recommended the ability of the court or interested parties to seek the appointment of an estate neutral. *See* Final Report at Section IV.A.3, *The Estate Neutral*. While the Chapter 11 trustee proposed by the SBRA does have some aspects of an estate neutral (*e.g.*, facilitation of the development of a consensual plan), it also blends in some of the concepts of a standing Chapter 13 trustee, which a majority of the Commission did not support implementing for small business cases in the Final Report.

• Automatic initial status conference: Under new section 1188, the court will be required to hold a status conference to further the resolution of the case within 60 days of the entry of the order for relief and the debtor will be required to file a report no later than 14 days before the status conference detailing the efforts that the debtor has taken and will take to attain a consensual confirmation. *See* SBRA § 2.

- In the Final Report, the Commission recommended that small business debtors be required to file a timeline for filing and solicitation of its Chapter 11 plan within 60 days of the petition date. The above provision does appear to implement the intent of the Commission's recommendation to provide the flexibility to small business debtors in the timing of filing a plan.

- Exclusivity and 90-day plan filing a requirement: Section 1189 of the SBRA provides that *only* the debtor may file a plan in a small business Chapter 11 case and, unless the court finds exceptional circumstances, the debtor must file the plan no later than 90 days after the order for relief. *See* SBRA § 2. The SBRA does not appear to have any provisions providing for the termination of exclusivity or specifically providing for what occurs if the debtor fails to timely file a plan.

  - Although the Commission recommended the filing of a timeline for plan confirmation in small business cases, the Final Report did not recommend a hard and fast 90-day deadline for filing a plan. Rather, the Commission suggested keeping the existing exclusivity deadlines set forth in Section 1121 of the Bankruptcy Code, which are not applicable in Subchapter V cases under the SBRA.

- The elimination of the disclosure statement: Unless the court orders otherwise, proposed sections 1181 and 1887 eliminate the requirement for small business debtors to file a separate disclosure statement. *See* SBRA § 2. Rather, new Section 1190 requires that the small business debtor's plan include a brief history of the business operations of the debtor, a liquidation analysis, and financial projections of the debtor's ability to make plan payments. *See id*.

  - While this aligns with the existing small business provisions of Chapter 11 that permit the court to combine the plan and disclosure statement, the Final Report did not specifically recommend removing the disclosure statement from small business cases altogether as is proposed in the SBRA.

- The elimination of the absolute priority rule in small business cases: Specifically, the SBRA includes a new section 1191(b) of the Bankruptcy Code that would permit confirmation of a small business Chapter 11 plan if all of the requirements of 1129(a), other than paragraphs (8) [acceptance by all impaired classes], (10) [acceptance by at least one impaired class, without including insiders], or (15) [payment of all disposable income of individual debtors during the life of the plan] of that section, are met so long as "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired, and has not accepted, the plan." *See* SBRA § 2. While the SBRA preserves the cramdown requirements of section 1129(b)(2)(A) for secured creditors, Section 1191(c) of the SBRA proposes changes the definition of "fair and equitable" in small business cases by requiring that the plan provide for all of the projected income of the debtor for 3-5 years to be applied to make payments under the plan, or that the value of the property to be distributed under the plan exceed the debtor's projected disposable income during such 3-5 year period. *See id*. Section 1191(c) further requires that the court find that (i) the debtor can either make the plan payments or there is a reasonable likelihood that the debtor will be able to make all payments under the plan, and (ii) the plan provides for appropriate remedies, including liquidation of non-exempt assets, in the event that payments are not made. *See id*.

  - A good portion of Part VII of the Final Report focuses on the problems for small business debtors arising from the existing requirement that nonconsensual plans comply with the absolute priority rule or otherwise meet the new value corollary thereto. Rather than the structure proposed by the SBRA, the Commission recommended that small business debtors be permitted to confirm cramdown plans that do not comply with the absolute priority rule so long as the economic interests of the equity retained by prepetition equity holders is limited to no more than 15 percent of the economic ownership interest in the reorganized debtor, with the remaining 85 percent of the economic interests in the reorganized debtor being provided to general unsecured creditors via preferred convertible stock with certain voting rights. The Commission further recommended that such a nonconsensual equity retention plan provide for holders of unsecured claims to receive, no less than annually, the reorganized debtor's excess cash flow for each of the three full fiscal years following the effective date of the plan. Thus, it appears that the SBRA attempts to incorporate some of the recommendations of the Commission but does not fully incorporate the recommended equity structure.

- <u>Plan payments to and distributions to creditors from the Chapter 11 trustee</u>: New section 1190(2) provides that the plan shall provide for "the submission of all or such portion of the future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan." *See* SBRA § 2. Similarly, section 1194 would provide for the Chapter 11 trustee to make payments to creditors under any confirmed small business plan and, in certain circumstances, the court may provide for payments to be made from the Chapter 11 trustee to secured creditors pre-confirmation. *See id*.

  - As noted above, the Commission was opposed the appointment of a standing Chapter 11 trustee akin to the existing Chapter 13 trustees. Yet, the SBRA does appear to require that all plan payments be made to and distributed to creditors by a Chapter 11 trustee.

- <u>Post-confirmation modification of "cram down" plans</u>: The SBRA proposes that a debtor may modify a plan confirmed under the small business cramdown provisions of 1191(b) so long as the modified plan continues to meet the requirements of 1191(b) and the court finds that circumstances warrant such modification after notice and a hearing. *See* SBRA § 2.

  - In the Final Report, the Commission did not appear to make any recommendations specifically regarding post-confirmation modification of small business plans. However, in the Final Report, the Commission did recommend that unsecured creditors holding preferred equity interests in a nonconsensual equity retention plan have voting rights with respect to any extraordinary transactions, though it is unclear whether the modification of the confirmed plan would fall within the voting rights of the unsecured creditors.

- <u>The granting of a discharge to small business debtors</u>: The SBRA proposes a new section 1192 of the Bankruptcy Code, which would authorize the court to grant a discharge under section 1141(d)(1)(A) to a small business debtor that completes all plan payments. *See* SBRA § 2.

  - The Commission did not appear to make any recommendations for small business debtors with respect to the existing discharge provisions of Chapter 11 in the Final Report.

- <u>Requirement for due diligence and consideration of defenses in all preference actions</u>: Section 3 of the SBRA, which is *not limited to cases under the new Subchapter V of*

Chapter 11, would insert a requirement into section 547(b) of the Bankruptcy Code that a trustee may only bring a preference action "based upon reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)." *See* SBRA § 3(a).

- Although not addressed in Part VII of the Final Report regarding small business cases, this provision of the SBRA does appear to implement some of the recommendations made by the Commission in Part V of the Final Report regarding administration of Chapter 11 bankruptcy cases. In particular, the Commission recommended that a trustee should be precluded from making a demand for or filing an complaint to recover an alleged preference unless "based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c)." Final Report at p. 148.

VII. PROPOSED RECOMMENDATIONS: SMALL AND MEDIUM-SIZED ENTERPRISE (SME) CASES

Most business bankruptcy cases filed in the United States involve small and middle-market enterprises. These businesses include family owned businesses, entrepreneurial ventures, and startup companies. They form the backbone of the American economy. As explained in one survey, "[a]ccording to the U.S. Economic Census, companies with 50 to 5,000 employees account for more employment than those with over 5,000."[981] This survey also noted that "in terms of output, the sheer number of mid-market firms accounts for the fact that, in aggregate, their revenues surpass those of the top 100 U.S. companies by capitalization and are equivalent to roughly 40 percent of the U.S. GDP."[982]

Nevertheless, small and middle-market enterprises are prone to preliminary setbacks and initial failures, and they can be among the hardest hit in economic downturns.[983] The chart below from the Bureau of Labor Statistics generally indicates that among new businesses, approximately 50 percent of those businesses fail within the first five years of operation and approximately 70 percent fail before their tenth anniversary.[984]

981 Deloitte Development LLC, Mid-Market Perspectives: America's Economic Engine — Competing in Uncertain Times 4 (2011), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_dges_competing_in_uncertain_times_09202011.pdf.

982 *Id. See also Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1, 4 (Nov. 15, 2012) ("The importance of facilitating reorganizations, especially for SMEs, cannot be overstated. Start-up and small businesses create and provide a significant portion of jobs in the United States. . . . For example, in 2010, 505,473 new businesses were started. These businesses employed over 2,456,000 people."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012), *available at* Commission website, *supra* note 55.

983 Donald R. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, 23 Cap. U. L. Rev. 413, 426–27 (1994) ("Larger businesses also tend to have more operational flexibility, and sometimes may weather economic slow-downs by shifting from one product line to another, or from one geographical area to another. In contrast, small businesses are less likely to have cash reserves, and they are generally undiversified in their products and customer base. Furthermore, small businesses are often in industries characterized by intense price competition. During inflationary times, they may not have the luxury of raising prices in order to compensate for rising operating expenses. Meanwhile, regulatory burdens and tax increases hit small business the hardest, depleting severely limited working capital.") (citations omitted); *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 2 (Nov. 15, 2012), *available at* Commission website, *supra* note 55 ("[A]lthough large U.S. corporations play an important role in the U.S. economy, CFA believes that an even greater role is played by small and medium-sized enterprises ("SMEs"). Commercial finance (in both its asset-based lending and cash-flow lending forms) has traditionally been, and continues to be, the backbone of financing for SMEs in the United States. Although many of the current suggestions for amending the Code (including some from Commissioners) are designed to address perceived problems arising in the chapter 11 cases of large corporations, these concerns are not necessarily applicable to chapter 11s of SMEs (which currently comprise the greatest number of chapter 11 cases).").

984 *See* Bureau of Labor Statistics, *Business Development Dynamics, Entrepreneurship and the U.S. Economy*, *available at* http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

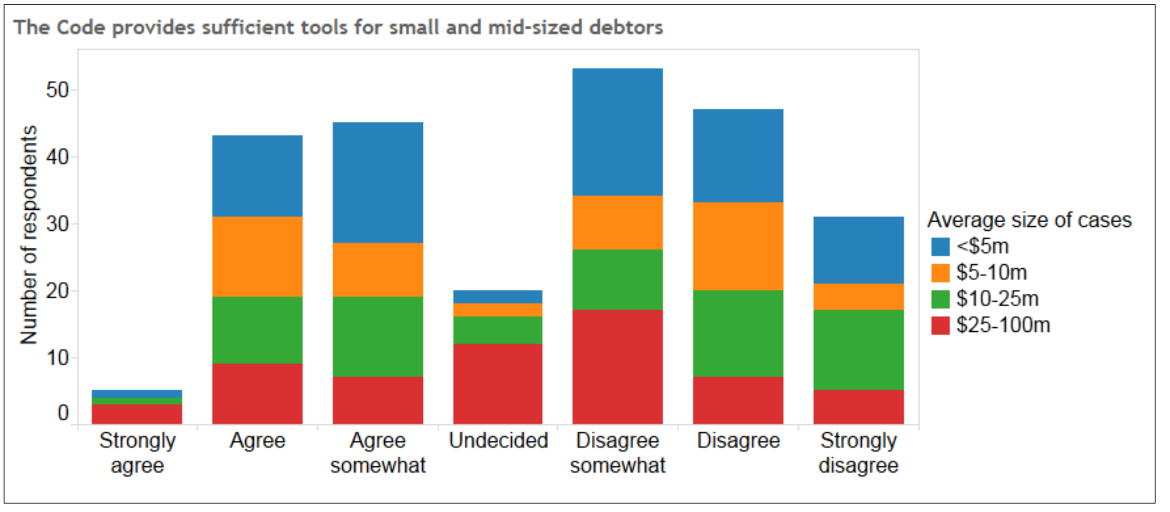
Survival Rates of Establishments, by Year Started and Number of Years Since Starting, 1994–2010 (%)																	
No. of Years Since Starting	Year																
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2	79.8	79.2	79.0	78.8	80.6	79.6	78.9	75.5	78.4	79.2	79.1	80.0	78.3	77.2	74.4	76.3	–
3	68.5	68.5	67.6	68.7	69.1	67.6	66.3	64.5	67.5	68.4	69.1	68.7	66.2	63.4	62.4	–	–
4	61.2	60.5	60.4	60.6	60.2	59.0	58.5	57.5	60.2	61.4	61.3	60.1	56.1	54.9	–	–	–
5	54.9	54.7	54.1	53.5	53.6	53.2	53.1	52.4	55.0	55.3	54.7	52.2	49.3	–	–	–	–
6	50.2	49.5	48.8	48.1	48.7	48.7	48.6	48.2	50.4	50.1	48.2	46.5	–	–	–	–	–
7	45.8	45.0	44.5	44.2	45.0	45.0	45.1	44.5	46.3	44.7	43.7	–	–	–	–	–	–
8	42.1	41.4	41.2	41.0	41.9	42.1	42.1	41.2	42.0	40.9	–	–	–	–	–	–	–
9	38.9	38.6	38.5	38.2	39.4	39.3	39.1	37.6	38.7	–	–	–	–	–	–	–	–
10	36.4	36.3	36.0	36.2	37.0	36.8	36.0	34.7	–	–	–	–	–	–	–	–	–
11	34.2	34.1	34.0	34.0	34.8	33.9	33.4	–	–	–	–	–	–	–	–	–	–
12	32.4	32.2	32.1	32.1	32.2	31.7	–	–	–	–	–	–	–	–	–	–	–
13	31.0	30.5	30.4	29.8	30.3	–	–	–	–	–	–	–	–	–	–	–	–
14	29.3	29.0	28.6	28.1	–	–	–	–	–	–	–	–	–	–	–	–	–
15	27.8	27.1	26.9	–	–	–	–	–	–	–	–	–	–	–	–	–	–
16	26.0	25.7	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
17	24.6	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Note: Dashes indicate not applicable.																	
Source: Bureau of Labor Statistics, Business Development Dynamics, Entrepreneurship and the U.S. Economy, *available at* http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.																	

In addition, established small and middle-market companies can experience failed acquisitions, underperforming product lines, overcapitalization, and other factors that contribute to financial distress and threaten their survival. Yet many commentators and practitioners assert that the Bankruptcy Code no longer works to help rehabilitate these companies.[985] As one witness testified, “Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender.”[986]

985 *See, e.g., Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (“[C]omplexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome.”), *available at* Commission website, *supra* note 55. *See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (“It is widely understood and agreed in the insolvency community that Chapter 11 is no longer a cost effective process in the middle market. . . . Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender.”), *available at* Commission website, *supra* note 55.

986 *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013), *available at* Commission website, *supra* note 55. *See also Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

The Commission heeded the concerns raised by several witnesses regarding the plight of small and middle-market enterprises in financial distress.[987] These perspectives aligned with the results of an empirical survey conducted by Professor Dalié Jiménez, as illustrated in the following chart:[988]



The Commissioners solicited the testimony and input of practitioners and judges familiar with small and middle-market cases and thoroughly studied the issues identified as barriers to effective reorganizations in this space. They also, with the assistance of the Reporter and a report from the governance advisory committee, reviewed the literature and empirical evidence on small business cases in chapter 11. The Commission strongly believed that the following set of principles for small and middle-market enterprises can have a significant and positive influence on the ability of these companies to effectively reorganize in and outside of chapter 11.

987 For example, one witness noted that data from the Census Bureau and the Bureau of Labor Statistics indicate that entrepreneurship has decreased since 1994. The witness suggested that changes in the Bankruptcy Code were partially to blame. *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 & n. 1 (Nov. 3, 2012), *available at* Commission website, *supra* note 55. *See also* Michelle J. White, *Bankruptcy and Small Business*, Reg. Mag. 18, Summer 2001 (arguing that the BAPCPA reforms would make entrepreneurs less likely to start businesses), *available at* http://object.cato.org/sites/cato.org/files/serials/files/regulation/2001/7/white.pdf.

988 *See* Dalié Jiménez, *ABI Chapter 11 Survey Results*, Am. Bankr. Inst. J., July 2014, at 11 (containing the results of Professor Jiménez's entire survey). Professor Jiménez found that "[a]bout 15% of the then 2,158 members of the Business Restructuring Committee responded to the survey, for a total of 322 responses. While the response rate could have been higher, this is typical of online surveys and in line with previous ABI surveys. Nonetheless, these findings must be interpreted with a grain of caution." *Id. See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

A. Definition of SME

Recommended Principles:

- For purposes of these principles, the term "***small or medium-sized enterprise***" ("***SME***") means a business debtor with —
  - (i) No publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's case; and
  - (ii) Less than $10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date.

  A debtor purporting to qualify as an SME under this definition must file a balance sheet reflecting a good faith estimate of its assets and liabilities as of the petition date with its chapter 11 petition.
- The court *sua sponte*, the U.S. Trustee, or a party in interest should be able to object to the debtor's indication in the petition that it satisfies subsections (i) and (ii) above and qualifies as an SME, but only on the grounds that the debtor does not in fact meet the definition of SME under the Bankruptcy Code. Such objection should be filed on or before 14 days after notice of the debtor's indication in the petition that it qualifies as an SME, and it should be heard on an expedited basis.
- In addition, if a business debtor satisfies subsection (i) above and has more than $10 million but less than $50 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates, the debtor may file a motion seeking to be treated as an SME in its chapter 11 case. Such motion must be filed with the debtor's voluntary petition or within seven days after the entry of the order for relief in an involuntary case. The court should grant such motion and classify the debtor as an SME only if the motion is timely filed and the court determines based on evidence presented at the hearing that treating the debtor as an SME in the chapter 11 case is in the best interest of the estate. Any objection to such motion should be filed on or before 14 days after the filing of the motion, and the motion and any objections should be heard on an expedited basis.
- The definition of SME does not include a "single asset real estate" case as defined in section 101(51B) of the Bankruptcy Code.
- The "***small business case***" and "***small business debtor***" provisions of the Bankruptcy Code should be deleted in their entirety.

Definition of SME: Background

The utility of chapter 11 for smaller companies is not a new concern. Shortly after the enactment of the Bankruptcy Code, commentators raised concerns regarding the ability of smaller debtors to confirm chapter 11 plans.[989] Congress attempted to address these concerns in 1994 by introducing a small business election provision in chapter 11.[990] The 1994 amendments defined "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."[991] A person qualifying as a small business could elect themselves into a fast-track chapter 11 plan process that allowed the court, among other things, to conditionally approve the debtor's disclosure statement and to combine the hearing on the adequacy of the disclosure statement and the approval of the plan.[992] The amendments also allowed the court to order that a committee of unsecured creditors not be appointed in a small business case.[993]

Congress further amended the small business provisions of chapter 11 in 2005 in response, at least in part, to the ongoing issues with small business cases identified by the National Bankruptcy Review Commission's (the "***NBRC***") study and report (the "***NRBC report***").[994] The NBRC report concluded that small business debtors fell into two categories: (i) a small number with a reasonable likelihood of reorganizing and succeeding as a going concern; and (ii) a larger number with no reasonable prospect of rehabilitation.[995] The NBRC suggested that reform focus on increasing the likelihood of success for those debtors who might succeed and reducing the amount of time a likely-to-fail debtor spends in chapter 11.[996]

The NBRC report concentrated to some extent on those small business debtors that were unlikely to rehabilitate.[997] The NRBC report indicated that small businesses benefited from the protections of chapter 11 — the automatic stay, retention of control of the business, ability to delay payments to creditors, and ability to delay formulating a chapter 11 plan — while administrative costs increased, even though there was no realistic prospect of rehabilitation.[998] Chapter 11 arguably only prolonged these debtors' imminent demise and reduced recoveries for creditors.[999] The NBRC proposed reforms to address these likely-to-fail debtors and to try to reduce overall cost and delay for small business debtors.[1000] These changes included establishing presumptive plan filing and plan confirmation

989 *See* LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 749–51 (1993) (discussing how the initial identical treatment of large and small business cases evolved).

990 *See id.* at 751–52 (describing how the procedures developed by Judge Small resulted in the small business reorganization pilot program in 1992 and ultimately the legislative changes to the Bankruptcy Code in 1994); James B. Haines, Jr. & Phillip J. Hendel, *No Easy Answers: Small Business Bankruptcies After BAPCPA*, 47 B.C.L. Rev. 71, 73 (2005).

991 11 U.S.C. § 101(51C) (1994).

992 *Id.* §§ 1121, 1125 (1994).

993 *Id.* § 1102(a) (1994).

994 NBRC Report, *supra* note 37. *See also* Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 Am. Bankr. L.J. 645 (2005).

995 NBRC Report, *supra* note 37, at 609.

996 *Id.*

997 *See* H. Rep. No. 109-31, Part 1, at 3 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89 (noting that the legislation includes "several significant provisions intended to heighten administrative scrutiny and judicial oversight of small business cases, which often are the least likely to reorganize successfully").

998 *See* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381, 382–83 (2007) (citing others who believe that chapter 11 allows firms that should be liquidated to linger on indefinitely).

999 NBRC Report, *supra* note 37, at 612–13 ("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.' 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.") (citing 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); 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).

1000 *See* H. Rep. No. 109-31, Part 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105 (stating that the "variety of time frames and enforcement mechanisms [were] designed to weed out small business debtors who are not likely to reorganize"); NBRC Report, deadlines,[1001] additional postpetition documentation requirements, more reporting, and changes to the burden of proof for small business debtors.[1002] In adopting these provisions, Congress also removed the elective nature of the small business provisions and amended the definition of the "small business debtor" that would be subject to these mandatory provisions.[1003]

At that time, some commentators testified before the NBRC that the reduced deadlines would provide too little time and shifting the burden of proof would be too onerous, and that these provisions would deprive debtors of a fair opportunity to reorganize in chapter 11.[1004] Others commented that the system was working relatively well and that bankruptcy judges were doing a good job of filtering failing firms from viable ones.[1005] Unfortunately, time has proven those commentators right to some extent. Witnesses before the Commission generally testified that chapter 11 is not working for small and middle-market debtors, and several of these witnesses suggested that certain of the deadlines imposed by the BAPCPA amendments were particularly challenging and counterproductive for small business debtors.[1006]

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supra note 37, at 609 (stating that for the large group of debtors with "no reasonable prospect for rehabilitation . . . the primary goal is to reduce the amount of time they consume in Chapter 11").

1001 NBRC Report, *supra* note 37, at 615.

1002 *Id.* at 618–25.

1003 *Id.* at 618. *See also* Haines & Hendel, *supra* note 990. Section 101(51D) defines "small business debtor" as follows:

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

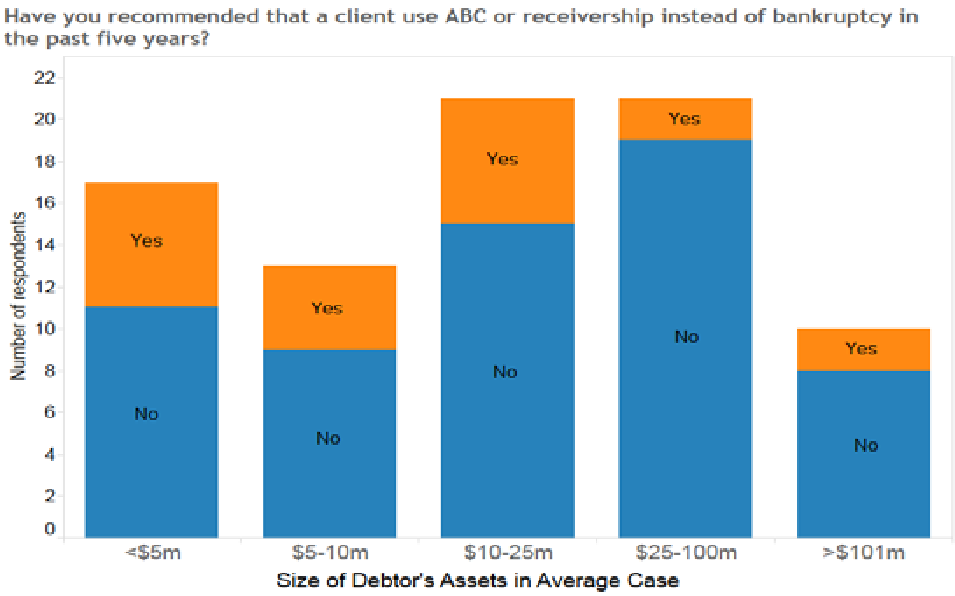
11 U.S.C. § 101(51D). Several commentators have criticized the definition as being too complex and difficult to apply in many cases. *See, e.g.,* Anne Lawton, *An Argument for Simplifying the Codes "Small Business Debtor" Definition*, 21 Am. Bankr. Inst. L. Rev. 55 (2013). For example, the types of assets at issue may give rise to questions concerning whether the debtor is a small business case or a single asset real estate case. *Id.* at 72–76. Likewise, determining whether liabilities are noncontingent and liquidated may not be a straightforward calculation. *Id.* at 83–88.

1004 NBRC Report, *supra* note 37, at 616.

1005 *See* Douglas G. Baird, *Remembering Pine Gate*, 38 J. Marshall L. Rev. 5, 15 & n. 35 (2004) ("The benchmark by which to judge the bankruptcy system in small cases is not the sheer number of businesses saved, but their ability to sort effectively and quickly. Most important is identifying those cases in which the debtor is only playing for time. The evidence suggests that bankruptcy judges can do this job exceedingly well. Indeed, the data are consistent with the conjecture that bankruptcy judges perform this job as well as a market actor subject to the same constraints.") (citing Morrison, *Bankruptcy Decisionmaking*, *supra* note 998). Morrison conducted an empirical study of nearly all the chapter 11 cases filed by corporations outside the real estate sector who filed in the Northern District of Illinois in 1998. He found that the bankruptcy process identified over 70 percent of nonviable firms within six months and 44 percent were identified within three months; only 8.5 percent of nonviable firms had not been identified by one year. *See* Morrison, *Bankruptcy Decisionmaking*, *supra* note 998, at 14. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). *See also* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009) (finding that the pre-BAPCPA system was successfully screening cases).

1006 *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) (stating it is nearly impossible to do anything but have a section 363 sale in the middle market), *available at* Commission website, *supra* note 55. "Middle-market companies just do not have either the management or financial resources to attempt to remain in Chapter 11 long enough to reorganize." *Id. See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (requesting that the BAPCPA plan deadlines be repealed because "the secured lender is concerned about these deadlines and consequently takes action (or requires the debtors to take action) months before these deadlines occur in order to reduce its credit risk — all of which hurts the flow of funds to the debtor and ultimately inures to the detriment of the reorganization process"), *available at* Commission website, *supra* note 55.

Moreover, several witnesses and commentators have observed an increasing use of state and federal law insolvency alternatives by small and middle-market enterprises in lieu of a chapter 11 filing.[1007] These alternatives include state and federal receiverships and assignments for the benefit of creditors ("***ABCs***") under state law.[1008] This testimony again generally aligned with the results of the empirical survey conducted by Professor Jiménez, as illustrated by the following chart:[1009]



In a receivership, a person — the receiver — is appointed by a court to take property into custody and preserve it; receiverships are often used as a method for liquidating entire businesses.[1010] Commentators argue that receiverships are attractive for several reasons: Receivers may be granted powers that are broader and more flexible than those under the Bankruptcy Code;[1011] nonbankruptcy courts are able to use summary remedies to allow, disallow, and subordinate the claims of creditors,

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1007 *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Apr. 19, 2013) (stating that the use of federal receiverships is growing in the insolvency community but noting that the federal statute on receiverships does not have well-developed processes and rules), *available at* Commission website, *supra* note 55; *Written Statement of John Haggerty: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (noting that there has been an increase in the use of out-of-court alternatives for turnarounds, restructurings, sales and liquidations, particularly for smaller businesses), *available at* Commission website, *supra* note 55.

1008 *See id. See also* Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255, 256 (2009) (stating that in 2003, about 540,000 small businesses closed their doors but only 34,000 filed for bankruptcy and that the "vast majority of small businesses resolve distress under state law"); Edward R. Morrison, *Bankruptcy's Rarity: Small Business Workouts in the United States*, 5 Euro. Co & Fin. L. Rev. 172 (2008) (asserting that federal bankruptcy filings account for only three to four percent of all business closures). *Accord* Edward I. Altman et al., *The Value of Non-Financial Information in SME Risk Management*, J. Credit Risk, Summer 2010, at 7 (distinguishing between failure and closure and citing a study that indicated about 33 percent of new businesses closed because they were unsuccessful) (citation omitted), *available at* http://people.stern.nyu.edu/ealtman/Altman-Sabbato-Wilson-JCR_2010.

1009 *See* Jiménez, *supra* note 988, at 79. Professor Jiménez found that "[m]ore than a quarter (26 percent) had been involved in an equity receivership in the past five years. Most of these (69 percent) noted that their participation in federal equity receivership cases had increased in the last five years, 27 percent thought it was about the same, and only 5 percent responded that it had decreased." *Id.*

1010 Business Organizations with Tax Planning § 155.01.

1011 M. Colette Gibbons et al., *Lien on Me*, Ohio Lawyer, May/June 2011,at 18; M. Colette Gibbons & Jason Grimes, *A Model Statute for Free-and-Clear Sales by Equity Receivers*, Am. Bankr. Inst. J., Mar. 2009, at 3. *See also* 16 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedures § 3925 (3d ed.) ("A receivership can drastically curtail existing property rights. . . . ."); SEC v. Black, 163 F.3d 188 (3d Cir. 1998) ("[W]here there is a receiver with equitable power in a proceeding before it, the District Court has wide discretion as to how to proceed."); SEC v. Hardy, 803 F.2d 1034 (9th Cir. 1986) ("[A] district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad."); SEC v. Safety Fin. Serv., Inc., 674 F.2d 368 (5th Cir. 1982) ("It is a recognized principle of law that the district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership.").

which promotes judicial efficiency and reduces litigation costs;[1012] lack of certainty in chapter 11 due to divergent case law;[1013] and lastly, receiverships are less time-consuming and costly than chapter 11 to liquidate property.[1014] Receivership has traditionally been considered an extraordinary remedy[1015] and may only be available in specific circumstances,[1016] particularly when statutory authority for the receivership is lacking.[1017]

An ABC involves a consensual transfer of assets by the debtor to an assignee who holds them in trust for the benefit of creditors.[1018] ABCs are a function of state law, with many states requiring court supervision of the ABC and with other states not requiring such oversight.[1019] The law governing ABCs, like the law covering receiverships, is often a mixture of common law and statutory law and varies significantly by state.[1020]

These state law alternatives are subpar remedies in many circumstances and present their own problems. For example, some debate a receiver's ability to sell property free and clear of liens without the consent of all lienholders.[1021] Case law is inconsistent as well.[1022] In an ABC, any nonconsenting creditors are not bound by any conditions contained in the assignment and the ABC does not displace even the consenting creditors' original claims, unless there is a release.[1023] And even though these nonbankruptcy procedures are generally faster and cheaper, they are also more private and generally less transparent.[1024] This may hide insider self-dealing or preferential treatment of certain creditors.[1025] Nevertheless, the prevailing perception that chapter 11 no longer works for small and middle-market enterprises has forced many companies to consider these alternatives.

1012 Gibbons & Grimes, *supra* note 1011, at 3 (citing SEC v. Basic Energy & Affiliated Res. Inc., 273 F.3d 657, 668 (6th Cir. 2001)). *See also* SEC v. Elliott, 953 F.2d 1560 (11th Cir. 1992), *rev'd in part on other grounds sub nom.* SEC v. Elliott, 998 F.2d 922 (11th 1993) (*per curiam*).

1013 Gibbons & Grimes, *supra* note 1011, at 3 (discussing the decision in *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), in which the court held that the sale of the debtor's assets was not free and clear of all liens when the price paid did not exceed the aggregate value of all liens on the property, in violation of section 363(f)(3)).

1014 *See* Business Organizations with Tax Planning § 155.01 ("Cost is often the major factor that makes a receivership attractive when compared to a federal bankruptcy proceeding").

1015 *Id.* (citing *Solis v. Matheson*, 563 F.3d 425, 437 (9th Cir. 2009), in which the court held that a receivership is an "extraordinary remedy" requiring "clear necessity" and should be "employed with the utmost caution"); *Peterson v. Islamic Republic of Iran*, 563 F. Supp. 2d 268, 277 (D.C. 2008) ("[A]ppointment of a receiver is an equitable remedy of rather drastic measure.")).

1016 *Id.* (citing *Case v. Murdock*, 528 N.W.2d 386, 388 (S.D. 1995); *Kuenning v. Broad & High Corp.*, 28 Ohio Misc. 211 (1971); *Hoiles v. Watkins*, 157 N.E. 557 (Ohio 1927)).

1017 *Id.* (stating that when a receiver is appointed according to equitable principles — rather than being authorized by statute — a higher showing of imminent danger to the property may be necessary).

1018 *See id.* (noting that "an assignment for the benefit of creditors is based on trust law, sometimes supplemented or modified by a specific state statute"). *See also* Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 Wash. U.L.Q. 1375 (2004) (discussing use of the ABC as an alternative to bankruptcy).

1019 *See generally* Geoffrey L. Berman, General Assignments for the Benefit of Creditors (second edition) (2006).

1020 *Id. See also* Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 4 ("An ABC, for example, is regulated by statute and overseen by courts in New York; it is unregulated and requires no court involvement in Illinois.").

1021 *Compare* Gibbons & Grimes, *supra* note 1011, at 2 (asserting that receivers are able to sell property free and clear without the consent of all lienholders, with some caveats, and acknowledging there is case law to the contrary), *with* Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, at 786–87 (arguing that the liabilities sometimes follow the assets in such asset sales, even when that is not what the parties intended). *See also* Mellen v. Moline Malleable Iron Works, 131 U.S. 352, 367 (1889); Broadway Trust Co. v. Dill, 17 F.2d 486 (3d Cir. 1927); Gibbons, *Lien on Me*, *supra* note 1011, at 19–20.

1022 *See* Director of Transp. of Ohio v. Eastlake Land Dev. Co., 894 N.E.2d 1255, 1261 (Ohio Ct. App. 2008) (holding that the court did not have the ability to authorize receiver to sell debtor's property free and clear of all liens over the creditor's objection) ("[W]e believe the courts do not have the power in receiver proceedings to take away lien rights in property which were vested by contract or by operation of law without the consent of lien holders.") (citations omitted); Quill v. Troutman Enters, Inc., 2005 WL 994676 (Ohio Ct. App. Apr. 29, 2005) (allowing receiver to sell property free and clear of liens over creditor's objection). *See also* Gibbons & Grimes, *supra* note 1011, at 2; M. Colette Gibbons & Melanie Shwab, Park National Bank *Affirms the Ability of Receivers to Sell Real Property Free and Clear of Liens*, Cleveland Metropolitan Bar J., Dec. 2010, at 14–16.

1023 Business Organizations with Tax Planning § 156.01.

1024 Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 8–9 (noting that it may be difficult for creditors to audit the distressed business outside of bankruptcy).

1025 *Id.*

Definition of SME: Recommendations and Findings

The Commission reviewed the history of the small business debtor provisions and the various proposals to address small business chapter 11 issues that have been proposed in the past, including the NBRC report discussed above and proposals by the Honorable A. Thomas Small of the U.S. Bankruptcy Court for the Eastern District of North Carolina[1026] and the American Bar Association's Select Advisory Committee on Business Reorganizations.[1027] It also considered empirical data, including thoughtful studies by Professor Anne Lawton and Professor Edward Morrison,[1028] and the industry and academic literature analyzing the financial distress of, and restructuring options for, small and middle-market enterprises. Finally, the Commission was aided in its deliberations by witness testimony.

The first question raised by the Commissioners concerned the need for, and the value of, separate chapter 11 provisions for different types of debtors. The Commissioners discussed the very large — or "mega" — chapter 11 cases that often dominated the media headlines. These cases certainly would benefit from the general reform principles proposed by the Commission, but the Commission did not believe that targeted chapter 11 provisions would further assist these debtors. The Commissioners also observed the relatively small number of mega cases filed on an annual basis and that many jurisdictions had adopted special local rules to address certain administrative and procedural issues that commonly arise in those cases.[1029]

The Commissioners did not generally believe, however, that a "one-size-fits-all" approach to chapter 11 is the best approach. In addition to the mega cases, the Commissioners found that the general reform principles being proposed identified and responded to key issues for the more established, upper-middle-market and larger company cases. These cases often struggled with liquidity early in the process, timing issues surrounding their exit strategy and value allocation, and case-specific investigations, litigation, or negotiations. These debtors also typically benefit from the advice and counsel of restructuring professionals and have more experienced management teams.[1030]

On the other hand, the Commissioners identified significant and troubling issues for small and lower-to-middle-market enterprises. (These principles refer to these companies as "small and medium-sized enterprises (SMEs).") In working to develop the parameters of companies in this

1026 *See, e.g.,* A. Thomas Small, *Suggestions for the National Bankruptcy Review Commission: Small Business Reorganization Chapter*, 4 Am. Bankr. Inst. L. Rev. 550, 550 (1996).

1027 *See* Karen M. Gebbia-Pinett, *Small Business Reorganizations and the SABRE Proposals*, 2 Fordham J. Corp. & Fin. L. 253 (2002).

1028 Anne Lawton, *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success,* 54 Ariz. L. Rev. 985, 995–1001 (2012); Morrison, *Bankruptcy Decisionmaking*, *supra* note 998; Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008; Morrison, *Bankruptcy's Rarity*, *supra* note 1008, at 3 (asserting that federal bankruptcy filings account for only three to four percent of all business closures).

1029 *See, e.g.,* Laura B. Bartell, A Guide to the Judicial Management of Bankruptcy Mega-Cases (2d ed. 2009), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/BkMega21.pdf/$file/BkMega21.pdf.

1030 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 15–16 (Nov. 15, 2012) ("The "mega" cases and the "pre-arranged" or "pre-pack" cases come to the Bankruptcy Court with many issues having already been pre-negotiated among the various constituencies in the debtor's capital structure. There is often consensus among the debtor and the various creditor groups and their representatives as to financing and management and, indeed, many times even agreement on an exit strategy. These creditor groups are in almost all cases represented by counsel. These cases differ markedly from the typical SME filing where the debtor has had little, if any, contact with any creditors other than its secured lender. Given these differences, and many more not touched upon herein, it seems that in "mega" cases, the consent of the parties should override the normal findings and statutory pre-requisites for such issues as DIP financing and other "first day" decisions, such as the payment of pre-petition obligations (including the payment of "critical vendors"). However, in the non-mega or non-pre-arranged cases, it is necessary to maintain the statutory construction set forth in the Code, tempered by the Court's judicial discretion and the exercise of business judgment."), *available at* Commission website, *supra* note 55.

space, the Commissioners discussed companies that have less experienced management teams,[1031] relatively smaller pools of assets and liabilities, relatively smaller revenue streams,[1032] challenges with understanding the nature of their financial issues or the potential tools available to help them address those issues,[1033] and vested equity owners who likely either founded the company or help manage the company.[1034] The Commissioners also stressed the importance of these companies possessing viable business models, recognizing that chapter 11 should not be used to delay the inevitable failure of a company. The Commissioners firmly believed, however, that many of these SMEs were failing not because of fatally flawed business models, but because they were not receiving the assistance they needed in the context of a financial restructuring. This belief has been supported by witness testimony and some of the related literature.[1035]

1031 Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 427–28 ("Small business managers may be unable to afford adequate managerial training for themselves or their employees, or regularly to hire accountants, bookkeepers, and other professional persons to assist their monitoring efforts. As a result of these factors, they may not discover that their business is in serious financial distress until the situation has deteriorated beyond the point of repair.").

1032 Small businesses often have higher debt-to-equity ratios than larger firms, and financing tends to come in the form of short-term bank financing for which they generally pay higher interest rates. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 ("As a result of these real limits on obtaining capital, small businesses often confront cash flow problems. Without available funds, they may be unable to exploit market opportunities in their purchase of raw materials and inventory, or to pursue attractive investment opportunities. Cash flow constraints may amplify the ramifications of simple management errors and, in less prosperous times, make small businesses more susceptible to default."); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. Small & Emerging Bus. L. 181, 194–95 (2000) ("Inadequacy of financial resources, combined with little leverage and market power, can lead to a host of other difficulties such as shortage of operating funds, lack of cash flow, and lack of access to long-term credit. The difficulty in obtaining long-term financing, which leads to heavy reliance on short-term credit (often in the form of credit cards or personal borrowing by the proprietor), is regarded by many writers as one of the most significant reasons for small business failure. Short-term financing allows the business to continue operations without profit for a period of time, but leaves it illiquid and unable to absorb fluctuations in cash flow.").

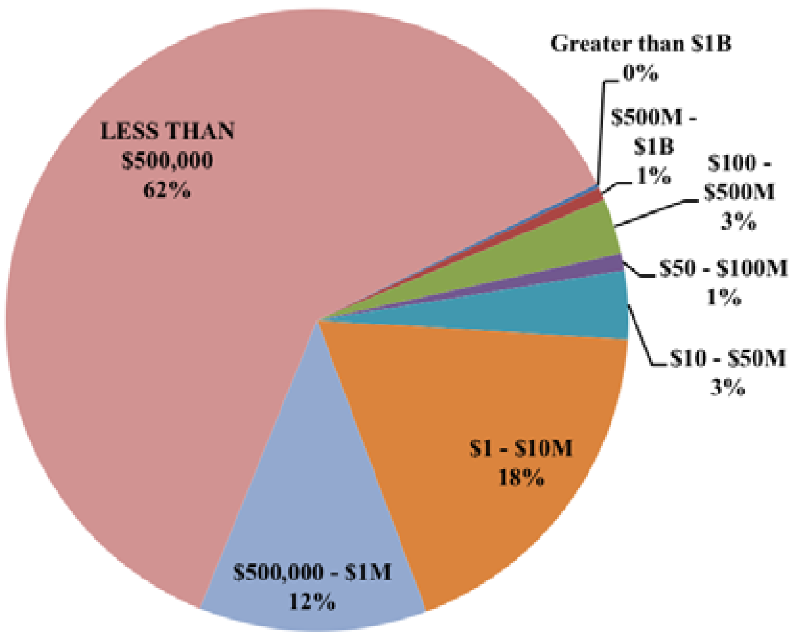
1033 *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) ("[Small business debtors] often lack the resources to recruit new management or hire experienced insolvency professionals. Their reorganization is also made more difficult by challenges that are common to smaller businesses, such as lack of proprietary products, customer concentration, vendor concentration, difficulty in raising capital, and relative insignificance to many of their lenders and creditors. While it might take the experienced turnaround professional only weeks to determine if the company is a candidate for turnaround and restructuring, the aforementioned circumstances make rehabilitation more challenging and time consuming."), *available at* Commission website, *supra* note 55; Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 (noting that small businesses are less likely to have cash reserves and do not have a diverse product line or diverse customer base; also stating that "small business managers may be less likely to detect the symptoms of financial distress at the very earliest stages" because of their short-term perspective); Blum, *supra* note 1032, at 195.

1034 *See, e.g.,* Haines & Hendel, *supra* note 990, at 85 (noting that small business managers are often the owners and discussing how bankruptcy can be a significant distraction); LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 758 (noting that the market for small companies is virtually nonexistent because "[w]ithout their owner-managers, most have no value at all"); LoPucki, *The Debtor in Full Control*, *supra* note 999, at 264 (noting that owner-managers exist in a significant majority of all reorganizing companies); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Surv. Am. L. 9, 39–42 (1991) (noting that owner-managers of small businesses may be able, despite the absolute priority rule, to retain control of the emerging company by purchasing the equity for new value); Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 425 (stating that because of the absolute priority rule, the owner-managers common in small businesses may be reluctant to file a petition before the company is in dire condition because in bankruptcy, they risk losing their financial interests in the business).

1035 *See, e.g.,* Robert N. Lussier, *Reasons Why Small Businesses Fail*, 1 Entrepreneurial Exec. 10, 11–14 (1996) (noting that there is no agreement on the factors that cause small businesses to succeed or fail but noting that lack of adequate financing is among the most commonly cited factors for failure); Teresa A. Sullivan et al., Financial Difficulties of Small Businesses and Reasons for Their Failure 23–24 (1998), *available at* http://archive.sba.gov/advo/research/rs188tot.pdf; Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499, 556–59 (1999) (finding that in a survey of small business debtors, the most cited reason (38.5 percent) for bankruptcy was financing issues such as high debt service, loss of financing, or inability to get financing); *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("Without the historical secured lender coming forward on Day 1, the middle-market Chapter 11 case usually cannot survive until the final hearing. Consequently, those Code provisions, . . . which require the debtor to seek other financing and competitive rates, are in most cases irrelevant because the debtor — in almost all of the cases over which I presided — had difficulty maintaining its existing credit relationships upon the filing of a bankruptcy petition, much less discovering alternative relationships."), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (Apr. 19, 2013) ("While the pre and post BAPCPA provisions are necessary for financial markets to function, they did not properly take into account their use as financing vehicles. When the principal lender to a business has the absolute ability to liquidate the assets subject to their agreement, the company is DOA on the steps of the bankruptcy court."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) ("[T]he challenges to finance smaller businesses have been well documented, even for those that are making a profit. The challenge is far greater for those companies

To assess the types of companies within the SME category, the Commission reviewed historical data regarding the types of companies filing for bankruptcy. The Commissioners analyzed data prepared from a database of all business bankruptcy filings (both chapter 7 and chapter 11) maintained by New Generation Research. These data included annual revenue for all but 670 of the 11,261 businesses that filed for chapter 7 or chapter 11 bankruptcy in 2013. These revenue data break down as follows:[1036]

Revenue of Debtors Filing for Bankruptcy in 2013



Note: Based on the New Generation data, 74% of companies that filed bankruptcies in 2013 had revenue below $1 million. In addition, based on this same dataset, 90% of the companies that filed bankruptcy in 2013 had 50 or fewer employees.

The Commissioners found the revenue and employee information very informative, but they acknowledged that these data points were not readily available on the petition date for any particular debtor. Accordingly, using these measures to define SMEs would be administratively difficult and, although feasible prospectively, such measures would not have the benefit of precedent in terms of interpretation and scope.

The Commissioners then reviewed data points more readily available for chapter 11 debtors: assets and liabilities. All debtors list these data points in a general manner in the bankruptcy petition and in a more specific manner in the schedules of assets and liabilities. Although also subject to

facing financial stress and for those seeking a DIP loan. Shareholders of smaller companies are also reluctant to lend money, even well documented and at reasonable interest rates, for fear that their loan might be treated as additional equity. Some file without a DIP loan in place, compelling management to spend [an] inordinate amount of time to obtain capital or face liquidation."), *available at* Commission website, *supra* note 55; *Written Statement of Robert Katz: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("While seemingly there is more money and more potential lenders/investors today than ever, it doesn't necessarily trickle down to the middle market. Some middle- and lowe-middle-market companies going through a Chapter 11 process are still having trouble attracting capital. . . ."), *available at* Commission website, *supra* note 55.

1036 Mr. Shrestha prepared this chart for the Commission based on data from the New Generation's Business Bankruptcy Filing Database. Accordingly, it was limited to public and large private companies.

definitional and interpretational issues, courts and practitioners have dealt with these concepts since the inception of the Bankruptcy Code and are more familiar with their application. The Commission asked Professor Anne Lawton to prepare several analyses of chapter 11 debtors' assets and liabilities based on the datasets she built for chapter 11 filings in 2004 and 2007.[1037] The data in Professor Lawton's dataset are taken from a random sample drawn from the population of chapter 11 cases filed in calendar year 2007.[1038] The population includes all chapter 11 cases filed in each of the 94 judicial districts in the United States. *Individual and business filers* alike are included, as are both voluntary and involuntary cases. The asset and liability data are summarized in the following charts:

Debtors' Assets Based on Schedules			
Asset Ranges	**Number of Cases**	**Percent of Total Number of Cases**	**Cumulative Percent of Cases**
$0 – $ 100,000	111	17.4%	17.4%
$100,001 – $500,000	119	18.6%	36.0%
$500,001 – $1 million	91	14.2%	50.2%
$1,000,001 – $2.19 million	117	18.3%	68.5%
$2,190,001 – $5 million	99	15.5%	84.0%
$5,000,001 – $10 million	47	7.4%	91.4%
$10,000,001 – $50 million	44	6.9%	98.3%
$50,000,001 – $100 million	4	0.6%	98.9%
Over $100 million	7	1.1%	100%
Total	**639**	**100%**	

Debtors' Liabilities Based on Schedules			
Liability Ranges	**Number of Cases**	**Percent of Total Number of Cases**	**Cumulative Percent of Cases**
$0 – $100,000	34	5.3%	5.3%
$100,001 – $500,000	111	17.3%	22.6%
$500,001 – $1 million	80	12.5%	35.1%
$1,000,001 – $2.19 million	149	23.2%	58.3%
$2,190,001 – $5 million	126	19.7%	78.0%
$5,000,001 – $10 million	56	8.7%	86.7%
$10,000,001 – $50 million	66	10.3%	97.0%
$50,000,001 – $100 million	8	1.2%	98.3%
Over $100 million	11	1.7%	100%
Total	**641**	**100%**	

The Commissioners carefully analyzed Professor Lawton's data and discussed its implications. They observed a natural breaking point in the data at the $10 million threshold.[1039] They examined the types of companies that might be captured by a definition that included companies with $10 million or less in assets or liabilities. They considered this question based on industry and geographic region, methodically walking through the different companies that could be captured by such a definition. Through this analysis, the Commissioners agreed that public companies (*i.e.*, those with publicly issued debt or equity securities) should be excluded from any SME designation in all instances. Moreover, at the end of these deliberations, the Commissioners determined that the $10 million or

1037 Professor Lawton used the same process to create both the 2007 and 2004 datasets. For a more detailed explanation of this process, see Lawton, *Chapter 11 Triage*, *supra* note 1028, at 995–1001.

1038 The initial sample consisted of 690 cases. The number of chapter 11 cases filed in 2007 was much smaller than that in 2004 and, hence, the population of cases from which the random sample was drawn was smaller. The initial random sample, however, was approximately the same in 2004 and 2007 — in the range of 10.5 percent to 10.8 percent of the respective year's population.

1039 Professor Lawton's 2004 dataset suggests that for *all* chapter 11 filings, 91.6 percent of the debtors had assets (based on schedules) of $10 million or less, and 88.2 percent had liabilities (based on schedules) of $10 million or less. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

less in assets or liabilities standard corresponded with the characteristics identified above of SMEs that are not being well served by current law.

The Commissioners recognized that this standard would capture around 85 percent to 90 percent of the chapter 11 filings, at least based on Professor Lawton's datasets and adjustments to exclude *individual* chapter 11 filings (the overwhelming majority of which fall under the $10 million threshold) and any small *public* companies.[1040] As previously noted, the Commission did not consider reform proposals for individual chapter 11 debtors, and it did not intend individuals to be covered by the recommended principles for SME debtors.

The Commissioners also discussed whether to include any of the factors or qualifications in the current definition of small business debtor. The Commission rejected making the definition overcomplicated and, as such, declined to require liabilities to be "noncontingent" or "liquidated," for example.[1041] It also agreed that a debtor should be able to qualify as an SME based on either assets or liabilities. Nevertheless, the Commission determined that the asset and liability calculations should be performed on a consolidated basis with any affiliates to ensure that smaller businesses within a larger, more complex corporate family were excluded. It further concluded that single asset real estate cases should be excluded from the definition of SME, but that such determinations should be based solely on the single asset real estate definition in section 101(51B) of the Bankruptcy Code.[1042]

Several Commissioners raised two related points: (i) nonpublic companies that do not qualify under this standard based solely on an asset or liability basis may have a very simple business and capital structure that could benefit from the tools and process proposed for small and middle-market enterprises, but (ii) a standard that allowed larger nonpublic companies to qualify for the process also could capture companies with very complex business and capital structures that need to filter through the general chapter 11 process. The Commissioners acknowledged the validity of both scenarios and examined alternatives to appropriately address each. The Commission agreed that nonpublic companies with assets or liabilities in excess of $10 million but less than $50 million should be able to request to be treated as an SME, but that the U.S. Trustee and parties in interest should have the ability to challenge the designation. The Commission also agreed that the court should only grant the request if it is in the best interests of the estate.

The Commissioners used this definition of SMEs and the underlying objectives to develop a comprehensive set of principles to guide and facilitate more effective chapter 11 cases for SMEs. Accordingly, the Commission voted to recommend the adoption of the SME principles and the deletion of the small business debtor and small business case provisions from the Bankruptcy Code.

1040 For example, in the 2007 dataset, Professor Lawton was able to identify 171 individual chapter 11 filings with liabilities of $10 million or less. Removing these individual filers (and the four individual filers with more than $10 million in liabilities) from the dataset reduced the percentage of business chapter 11 filings with $10 million or less in liabilities (based on schedules) to 83 percent. Similarly, in the 2004 dataset, the percentage of business chapter 11 filings with $10 million or less in liabilities (based on schedules) drops to 86 percent. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

1041 *See* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 992–93 (explaining complex calculation issues under current definition of "small business debtor").

1042 The Commissioners did not recommend maintaining the current qualifier in the definition of "small business debtor" in section 101(51D) that the debtor be involved in "commercial or business activities (including any affiliate of such person that is also a debtor under this title and *excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto*)." 11 U.S.C. § 101(51D) (emphasis added). *See also* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1026 n. 149 (explaining challenges in applying real estate exclusion in definition of "small business debtor").

B. General Application of SME Principles

Recommended Principles:

- A debtor that satisfies the definition of an SME should be subject to the principles set forth herein for SME cases without further action by the court, trustee, or debtor in possession.
- If an objection is timely filed to the debtor's indication in the petition that it qualifies as an SME under the Bankruptcy Code definition, such debtor should be treated as an SME unless and until the entry of an order of the court sustaining any such objection.
- If a debtor timely files a motion seeking to be treated as an SME, such debtor should be treated as an SME only upon the entry of an order of the court overruling any objections thereto and authorizing the debtor's designation as an SME.
- If a debtor qualifies or is designated as an SME, the court may for cause, after notice and a hearing, permit the SME debtor to use good faith estimates in compiling its valuation information package, as required by the principles, if audited or unaudited financial statements are not readily available. The court also may set a deadline by which the SME debtor should turn over its valuation information package, to a requesting party in interest. *See* Section IV.A.6, *Valuation Information Packages*.
- The general recommended principles proposed for chapter 11 cases apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

General Application of SME Principles: Background

As noted above, Congress introduced the small business provisions into the Bankruptcy Code as an elective process. Debtors who satisfied the original definition of "small business" could elect to proceed with the fast-track plan confirmation procedures. Congress removed the elective nature of the small business provisions in 2005 pursuant to the BAPCPA Amendments. The current provisions mandate small business treatment if, among other things, the debtor has less than $2,190,000 in total secured and unsecured debts and there is no active unsecured creditors' committee in the case.

Although the current small business provisions are mandatory and self-executing, several commentators have suggested that small business debtors are not self-reporting and may not be proceeding as small business cases. For example, Professor Robert Lawless observed that "there were 2,299 chapter 11s filed in 2007 where (i) the debtor was not an individual, (ii) [the debtor] said they had predominately business debts, and (iii) the total liabilities were between $50,000 and $1,000,000. Because very few small chapter 11 cases have unsecured creditors' committees, almost every one of these 2,299 cases should have identified as small business debtor, but only 36.8 percent did so."[1043] Now, the failure to self-identify as a small business debtor may be an oversight, it may be the result of the somewhat complicated definition of "small business debtor" described above, or it may be a desire to avoid the obligations and deadlines imposed on small business debtors under current law. Regardless of the reason, however, the consequences can be significant, including a determination that the small business debtor deadlines apply from the petition date, even if the non-designation is not corrected or is not deemed incorrect by the court until much later in the case.[1044]

General Application of SME Principles: Recommendations and Findings

The three primary objectives underlying the Commission's approach to the SME principles were (i) simplifying the process; (ii) reducing costs and barriers; and (iii) providing tools to facilitate effective reorganizations for viable companies. With these objectives in mind, the Commission determined that a hybrid approach to the application of the SME principles would work best. Accordingly, if the debtor is a nonpublic company that satisfies the asset or liability standard, it automatically invokes the SME principles. If the debtor is a nonpublic company that does not qualify, but it has assets or liabilities less than $50 million and believes that the SME principles would better serve its estate and stakeholders, it can make a request to be treated as an SME debtor.

The Commissioners were mindful that some companies might try to manipulate the standard or self-identify as an SME when the standard is not satisfied, but they believed that those concerns are appropriately addressed by allowing the U.S. Trustee and parties in interest to object to the designation in the petition or a debtor's request to be treated as an SME. In both instances, however, the Commissioners understood the importance of these matters being resolved quickly to allow the debtor either the full benefit of the SME principles or appropriate time to consider proceeding under the general chapter 11 principles. They believed that any delay in these determinations could significantly prejudice both the debtor and its stakeholders. The Commission also considered whether debtors would fail to self-report, as some commentators have suggested might be the case under the current law. Again, the Commissioners recognized that this was a possibility, but it believed that the SME principles incorporated appropriate incentives for the debtor and its estate so as to mitigate that risk.

1043 Bob Lawless, *The Disappearing Small Businesses (Designation) in Bankruptcy*, Credit Slips, (Apr. 30, 2010, 10:26 AM), *available at* http://www.creditslips.org/creditslips/2010/04/the-disappearing-small-businesses-designation-in-bankruptcy.html.

1044 *See, e.g., In re* Display Grp., Inc., 2010 WL 4777550 (Bankr. E.D.N.Y. Nov. 16, 2010). Notably, the U.S. Trustee reviews a debtor's chapter 11 petition and generally has 30 days following the section 341 meeting of creditors to object to the debtor's designation or non-designation as a small business case. *See* Fed. R. Bankr. P. 1020(b) (2011).

C. Oversight of SME Cases

Recommended Principles:

- The debtor should be permitted to operate as a debtor in possession with all rights, powers, and duties set forth in section 1107 of the Bankruptcy Code and subject to the appointment of a chapter 11 trustee for cause under section 1104.
- A committee of unsecured creditors under section 1102(a) should not be appointed in an SME case unless an unsecured creditor or the U.S. Trustee files a motion with the court requesting the appointment of a committee and the court, after notice and a hearing, determines that the appointment is necessary to protect the interests of unsecured creditors in the case.
- If the debtor does not satisfy the Bankruptcy Code definition of SME but files a timely motion to be treated as an SME in the chapter 11 case, the U.S. Trustee should not appoint a committee of unsecured creditors unless the court denies the debtor's motion. The U.S. Trustee should suspend its ordinary appointment process pending resolution of the debtor's motion.
- If the debtor qualifies as an SME or is designated an SME by the court, the notice of the chapter 11 case served upon creditors should explain that the U.S. Trustee will not appoint a committee of unsecured creditors in the case unless such committee is requested by an unsecured creditor or the U.S. Trustee and the court orders such appointment. If the debtor indicates in its petition that it qualifies as an SME, such notice also should explain that parties in interest have 14 days from the date of such notice to object to the debtor's treatment as an SME.
- The court *sua sponte*, the U.S. Trustee, the debtor in possession, or a party in interest should be able to request the appointment of an estate neutral that also has the authority to advise the debtor in possession on operational and financial matters, as well as the content and negotiation of its plan. The standard for approval of an estate neutral and the U.S. Trustee's authority to appoint the estate neutral, if ordered by the court, should be governed by the general principles on estate neutrals. *See* Section IV.A.3, *The Estate Neutral*.
- Any estate neutral should represent the interests of the estate and be paid by the estate. The Bankruptcy Code could establish a fee structure available for the estate neutral in an SME case to control costs and increase certainty. Such structure could be based on the size of the case or the amount of creditor distributions.

Oversight of SME Cases: Background

As discussed above, the debtor in possession model used in chapter 11 cases makes oversight of the case particularly important.[1045] In most cases, the Bankruptcy Code establishes the U.S. Trustee and the committee of unsecured creditors as the statutory watchdogs in the case. Both of these parties have the ability to oversee and investigate certain aspects of the case and to appear and be heard with respect to matters pending in the case.[1046] (In addition, other creditors and equity security holders have standing to appear and be heard in the case under section 1109 of the Bankruptcy Code.) Nevertheless, in many SME cases, the U.S. Trustee may not be able to appoint a committee of unsecured creditors typically because of a lack of creditor interest in serving on the committee.[1047]

The lack of creditor engagement was one reason cited by Congress in using the absence of a committee as a defining feature of a small business case. The legislative history of the BAPCPA Amendments explains:

> Most chapter 11 cases are filed by small business debtors. Although the Bankruptcy Code envisions that creditors should play a major role in the oversight of chapter 11 cases, this often does not occur with respect to small business debtors. The main reason is that creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases.[1048]

If an unsecured creditors' committee is not appointed in the small business debtor case, the debtor may drift in its case, achieving little, or it may cede to the desires of its secured creditors, even if those objectives do not align with the best interests of the estate.[1049] Accordingly, although the absence of a committee or creditor engagement may correspond to the size of the debtor or the complexity of the case, it does not mean that the debtor does not need oversight or assistance in the case.[1050]

Oversight of SME Cases: Recommendations and Findings

The Commission viewed the administrative and oversight functions in an SME case as critical to the utility and effectiveness of the SME principles. The Commissioners wanted to develop principles that encouraged SMEs to file chapter 11 cases when appropriate, which meant reducing costs, simplifying disclosures and the process, and providing a way for the prepetition managers to stay in control of the business with some

1045 In the debtor in possession model, the business's prepetition board of directors, officers, and managers continue to manage the company's affairs and make decisions regarding the business and the reorganization. Some critics of the debtor in possession model argue that these prepetition actors contributed to the business's failure and also express concern that the prepetition management may not be aligned with the best interests of the estate. *See* Section IV.A.1, *The Debtor in Possession Model*.

1046 For a general discussion of the parties overseeing the debtor in possession in chapter 11, *see* Butler, et al., *supra* note 77. *See also* 11 U.S.C. § 1103 (detailing duties of statutory committees); *id.* § 1104 (appointment of trustee); *id.* § 1109 (explaining standing of parties in interest).

1047 *See, e.g.,* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119 ("The reason for such a low rate of committee formation [in SME cases] is that in most cases an insufficient number of creditors were willing to serve.").

1048 *See* H.R. Rep. No. 109-31, pt. 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89.

1049 *See Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Apr. 19, 2013) (ASM Transcript) ("[T]he case I worry about is th[e] case . . . with no committee and you have a debtor who is often lock-step with their secured creditor, because they have no choice but to be lock-step with their secured creditor, and there is nobody to tell me when there's a problem in the case."), *available at* Commission website, *supra* note 55; Blum, *supra* note 1032, at 199–201 ("[M]any small business debtors are left to operate too freely in chapter 11 without adequate control [by a unsecured creditors' committee].").

1050 This concept was a significant motivator for the BAPCPA reforms. Blum, *supra* note 1032, at 201 ("The central component of the proposed [BAPCPA] reform is the creation of an alternative monitoring system to compensate for lack of creditor involvement in the case. In essence, it demands a more aggressive role of the U.S. Trustee and the court as a substitute for the lack of creditor vigilance and increases the accountability of the [small business] debtor by placing greater responsibility on it to provide information about its business affairs and to move with reasonable speed in formulating and obtaining approval of its strategy for rehabilitation.") (citing NBRC Report, *supra* note 37, at 643).

financial guidance and counseling when needed. These factors allowed the Commissioners to reflect on various alternatives for structuring the SME principles, including a chapter 13-like process for SMEs.

Some Commissioners suggested that the best oversight for SME cases was a standing trustee system similar to that used in the chapter 13 context. In chapter 13 cases, the U.S. Trustee appoints a standing trustee in each jurisdiction. The trustee represents the estate, and he or she oversees the administration of the case, including the confirmation of, and distributions under, the debtor's rehabilitation plan. The trustee does not represent the debtor, but he or she may consult with the debtor, including with respect to issues in the proposed rehabilitation plan. A few Commissioners even suggested either raising the chapter 13 debt limits to permit small businesses to file under chapter 13 or incorporating a more chapter 13-like process into chapter 11 for small businesses.[1051]

Most Commissioners strongly rejected the notion of either a standing trustee for SMEs or a chapter 13-like process for SME cases. These Commissioners noted that small business cases are not simply big chapter 13 cases. They highlighted the structural differences in business cases, including the debtor's contractual relationships with vendors and suppliers and its obligations to customers. SMEs also have employees to consider and operational issues that may complicate their restructuring alternatives. Finally, these Commissioners highlighted the likely reluctance of SMEs to file bankruptcy cases if the administration of their cases and perhaps their businesses would be turned over to a standing trustee.

The Commissioners then considered whether the traditional unsecured creditors' committee structure was an effective oversight mechanism for SME cases. They reflected on the witness testimony concerning the costs associated with unsecured creditors' committees, particularly in smaller cases.[1052] They also noted the creditor apathy that might prevent the formation of a committee in the first instance in SME cases.[1053] Most Commissioners agreed that committees could be effective in SME cases if creditors were engaged and representative of the general unsecured creditor body, and if costs could be contained. They also agreed, however, that satisfying both of these criteria in an SME case was likely the exception rather than the rule.[1054]

The Commissioners analyzed whether an estate neutral might provide appropriate oversight in SME cases when a committee was not appointed and when the SME debtor needed monitoring or assistance.[1055] They reviewed the witness testimony on the types of tools that witnesses believed would be helpful to SME debtors. For example, the Honorable Barbara J. Houser of the U.S. Bankruptcy Court for the Northern

1051 For a similar proposal that would create a process similar to chapter 12 for small business debtors, *see* Haines & Hendel, *supra* note 990.

1052 *See Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (citing professionals' fees associated with unsecured creditors' committees as one of the bankruptcy process obstacles facing small business debtors), *available at* Commission website, *supra* note 55.

1053 *See, e.g.,* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119; Honorable A. Thomas Small, *Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305, 320–21, 320 n. 74 (1993) ("In most cases, however, unsecured creditors are apathetic and creditors' committees are ineffective, particularly in smaller Chapter 11 cases. Removing the creditors' committee would, however, benefit the debtor by eliminating the possibility that a creditors' committee might incur substantial professional fees that could easily jeopardize confirmation of the debtor's plan.").

1054 *See id.*

1055 *See, e.g., Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) (stating that it could take an experienced turnaround professional only a few weeks to determine if a debtor's business is viable, whereas it would likely take an unassisted small business debtor much longer), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Melanie Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Nov. 15, 2012) (noting there is very little oversight in most small business cases and that these cases seem to "live" from one emergency to the next), *available at* Commission website, *supra* note 55.

District of Texas suggested that "a third party who is more of a financial person, who could come in and evaluate the viability of the business,"[1056] may be of assistance to both the court and the debtor in possession in assessing the debtor's prospects for reorganization. Several Commissioners observed that the estate-neutral concept might apply particularly well in SME cases. The court could appoint an estate neutral for specific purposes, including a financial review of the debtor, consulting with the debtor concerning its finances and restructuring options, or investigating the debtor's affairs when necessary or appropriate. The estate neutral, with court authority, also could assist the SME debtor in developing its chapter 11 plan, which would provide oversight of the debtor in possession and a counterbalance to any particular individual creditor influence in the case. Although the estate neutral would impose an additional cost on the estate, the Commissioners believed that the courts could and should closely monitor the fees and expenses of the estate neutral and could even use caps or budgets to protect the estate.

On balance, the Commission voted to recommend the use of estate neutrals to assist SME debtors achieve effective outcomes in appropriate cases. The Commissioners underscored the case-by-case nature of this inquiry and, accordingly, declined to make it a mandatory appointment. They specifically found, however, that if the court orders the appointment of an estate neutral, the U.S. Trustee should be the party responsible for the appointment of the neutral to ensure objectivity and fairness in the process. The Commission also determined that the U.S. Trustee and parties in interest should be able to request the appointment of a committee in an SME case. As noted above, if there is creditor interest, a committee may be very valuable in an SME case. Nevertheless, the Commissioners found no basis for the existence (or non-existence) of a committee to affect an SME designation. They also believed that the cost of, and the historical issues with, appointing a committee in smaller cases supported a default rule of no committee appointment.

D. Plan Timeline in SME Cases

Recommended Principles:

- Within 60 days of the entry of the order for relief, the SME debtor should develop and file with the court a timeline for filing and soliciting acceptances of its plan.
- If an estate neutral or a committee is appointed, the SME debtor should consult with such estate neutral or committee in developing its timeline.
- After the SME debtor files its timeline for filing and soliciting acceptances of its plan, the court should enter an order under section 105(d)(2)(B) setting the deadlines for the SME debtor's plan process.
- The SME debtor should be subject to the exclusivity periods provided in section 1121.

1056 *Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 29 (Apr. 19, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55.

Plan Timeline in SME Cases: Background

The Bankruptcy Code, as amended in 2005, requires that a debtor's chapter 11 plan be confirmed within 45 days of its filing. Several witnesses before the Commission testified that this is nearly impossible for small business debtors to achieve.[1057] Although it is possible to obtain a continuance, one witness noted that the burden for doing so is quite high, and that there is confusion regarding what the court must find and how it must make the necessary determinations, given the tight timelines and significant requirements.[1058] Thus, practically speaking, even viable small business debtors face considerable challenges to confirming a plan.

The Bankruptcy Code also provides that a small business debtor *must* file the chapter 11 plan within 300 days of the petition date.[1059] One witness noted that the 300-day deadline creates interpretive and practical problems similar to those identified above for the 45-day deadline, plus gives rise to additional concerns.[1060] For example, confusion exists regarding the application of the provision to parties other than the debtor, and the Bankruptcy Code does not specify the effect of an amended plan.[1061] The Bankruptcy Code also does not address the consequences for failure to submit a plan by the 300-day deadline.[1062]

Plan Timeline in SME Cases: Recommendations and Findings

The Commissioners debated the utility of firm deadlines in the context of SME cases. They understood the need to assess the viability of a debtor earlier rather than later in the case; no party benefits from prolonging a dismissal and incurring additional costs and expenses that cannot be paid. They also discussed the danger of handcuffing debtors to artificial deadlines that might not facilitate the debtor's reorganization or serve the interests of the estate in the particular case.

The Commission reviewed the recommendations of the advisory committee, which focused on helping both viable and nonviable debtors reach their fate efficiently. The advisory committee's recommendations included simplifying the definition of "small business debtor," and eliminating the 300-day plan proposal and 45-day plan confirmation deadlines for small business cases. The Commission also considered reforms suggested by witnesses, including more discretion for

1057 *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("[E]ven when these [small and medium-sized] businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome."), *available at* Commission website, *supra* note 55.

1058 *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–6 (Apr. 19, 2013), *available at* Commission website, *supra* note 55. *See also* 11 U.S.C. § 1129(e) (providing that the court shall confirm a plan within 45 days for small businesses, unless time is extended in accordance with section 1121(3)(3)); *id.* § 1121(e)(3) ("[T]he time periods . . . may be extended only if — (A) the debtor, after providing notice to parties in interest (including the United States trustee), demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (B) a new deadline is imposed at the time the extension is granted; and (C) the order extending time is signed before the existing deadline has expired.").

1059 11 U.S.C. § 1121(e) ("In a small business case . . . the plan and a disclosure statement (if any) shall be filed not later than 300 days after the date of the order for relief. . . .").

1060 *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–7 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

1061 *Id.*

1062 Although the Bankruptcy Code does not address the consequences of the failure to file a plan within the 300-day period, "the consensus appears to be that if no party files a plan within the 300-day period, no relief can be afforded and the case must be dismissed." *Id.*

bankruptcy judges concerning the procedures in small business cases,[1063] and additional clarification regarding the standard of review and procedural requirements if the current 45- and 300-day confirmation and plan deadlines remain in place.[1064]

The Commissioners worked to develop a process striking an appropriate balance between the need to assess the viability of an SME debtor case early while still allowing viable SME cases a reasonable opportunity to succeed. The Commission voted to recommend a mandatory requirement that the SME debtor file a timeline for filing and soliciting acceptances of its chapter 11 plan within 60 days of the petition date. It set this deadline to allow time for the SME debtor to settle into the chapter 11 case, resolve any issues relating to its SME designation, and consult with any committee or estate neutral appointed in the case, but still allow the court time to develop deadlines for the filing and solicitation of a chapter 11 plan consistent with other provisions of the Bankruptcy Code, such as the debtor's exclusivity periods under section 1121. The Commission determined that section 105(d)(2)(B) adequately authorizes the court to establish these deadlines, and that the Bankruptcy Code should be amended to simply require the court to exercise this authority in SME cases.

E. Plan Content and Confirmation in SME Cases

Recommended Principles:

- A chapter 11 plan in an SME case should provide for the following treatment of allowed claims and interests in the case:
    - o Payment of all administrative and priority claims in accordance with section 1129(a)(9) of the Bankruptcy Code.
    - o Bifurcation of each undersecured claim into an allowed secured claim in accordance with section 506 and a general unsecured claim for any deficiency claim; neither section 1111(b) nor section 1129(a)(7)(B) should apply in an SME case.
    - o Distributions to secured creditors (i) as provided in the plan and accepted by each class of secured creditors; or (ii) in accordance with section 1129(b)(2)(A).
    - o Distributions to unsecured creditors (i) as provided in the plan and accepted by each class of unsecured creditors; (ii) in accordance with section 1129(b)(2)(B) (subject to the recommended principles codifying

1063 *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("[I]t is essential that the Bankruptcy Court have flexibility to exercise judicial supervision regarding the SME debtor's business judgment when dealing with secured credit. The reasons are many but in most instances, these middle-market cases seemingly 'live' from one emergency to the next and therefore legislating 'fixed' criteria when it comes to the treatment of secured debt would not be in the best interest of promoting reorganization. It is not at all unusual in these middle-market Chapter 11 cases for a deadline or a budget requirement to be missed which, but for the Court's intervention and ability to step in and permit the waiver of an otherwise arbitrary provision, would lead to the automatic lifting of the automatic stay or the dismissal of the case without hearing or opportunity to be heard."), *available at* Commission website, *supra* note 55.

1064 *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–7 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

the new value corollary); or (iii) as provided below for an ***SME Equity Retention Plan***. *See* Section VI.C.2, *New Value Corollary*.

- o Prepetition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that (i) all impaired classes have accepted the plan; (ii) the plan complies with section 1129(b) (subject to the recommended principles codifying the new value corollary); or (iii) the plan complies with section 1129(b)(2)(A) and provides impaired classes of unsecured creditors that have rejected the plan with preferred stock, or similar economic interests, in the reorganized debtor as described below (an "***SME Equity Retention Plan***").

- The court should confirm an SME Equity Retention Plan that is not accepted by any class of unsecured claims only if:
  - o (i) The prepetition equity security holders will continue to support the debtor's successful emergence from chapter 11 by remaining involved, on a basis reasonably comparable to their prepetition involvement, in the ongoing operations of the reorganized debtor; and (ii) the reorganized debtor will pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. The debtor should file a budget with its disclosure statement and chapter 11 plan that describes the excess cash flow calculation method and includes projections of excess cash flow for the three fiscal years following the effective date of the plan.
  - o The prepetition equity security holders receive or retain 100 percent of the common stock, or similar ownership interests, issued or outstanding as of the effective date entitling the holders as a class to receive 15 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.
  - o The prepetition unsecured creditors as a class receive 100 percent of a class of preferred stock, similar preferred interests, or payment obligations issued by the reorganized debtor on the effective date in accordance with the chapter 11 plan with the following features (referred to as the "***creditors' preferred interests***"): (i) *pro rata* voting rights, limited to voting only on the extraordinary transactions identified in these principles; and (ii) entitlement as a class to receive 85 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.
  - o The creditors' preferred interests mature on the fourth anniversary of the effective date, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full

face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.

- o The following kinds of post-effective date transactions are deemed "***extraordinary transactions***" subject to the vote of holders of creditors' preferred interests: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) the sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. An extraordinary transaction should require at least an absolute majority vote of the holders of creditors' preferred interest, but the chapter 11 plan may require a higher level of approval. Whether an extraordinary transaction has been approved by the requisite majority vote (or such higher level as required by the plan) should be determined in accordance with applicable state entity governance law.
- o The consummation of an extraordinary transaction without the requisite approval should constitute a default under the chapter 11 plan, and holders of creditors' preferred interests should have the ability to request appropriate relief for such breach from the court that confirmed the plan. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.

- The general recommended principles proposed for chapter 11 plans apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

Plan Content and Confirmation in SME Cases: Background

Many commentators agree that chapter 11 is failing for small business debtors, but they disagree on both the cause and solution to this problem. As discussed above, some suggest that the deadlines concerning the plan process pose significant barriers. Others suggest that the plan process itself and the confirmation standards make emergence from chapter 11 almost impossible for small business debtors.[1065] Still, others have posited that reorganization is simply not feasible for small business debtors, benefits only the business owner, and that going concern sales may be a more effective restructuring option for these debtors.[1066]

The Commission received testimony from several witnesses arguing that the absolute priority rule[1067] and courts' disparate treatment of the new value corollary doom many small business debtors' plans.[1068] As Judge Houser explained:

> So, where a small to mid-sized business debtor cannot pay its unsecured claims in full with a market rate of interest over the life of the plan (a common occurrence), the junior class of interest holders may not receive or retain any property under the plan "on account of" their former interests. This is because of the application of what we call the absolute priority rule. The application of this rule and the so-called "new value exception" to it in small to mid-size Chapter 11 cases proves problematic.[1069]

Witnesses suggested that this uncertainty in the plan process can cause delay and expense, and can even deter filings in the first instance.[1070]

1065 *Id.* at 1 ("The complexity, time and costs of the Chapter 11 process impose obstacles that small businesses often cannot overcome."); *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("As Judge Dow has already observed, the complexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome. But, even when these businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome."), *available at* Commission website, *supra* note 55.

1066 Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, 753, 786–89 (2002) (noting that Sweden's insolvency code only provides for the sale of an insolvent firm and that it works well for both large and small businesses, and that many such small business debtors are run by "marginally competent owner-managers" with few corporate assets and few long-term employees). *See also* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005) ("The typical Chapter 11 debtor is a small corporation whose assets are not specialized and rarely worth enough to pay tax claims. There is no business worth saving and there are no assets to fight over. The focal point is not the business, but the person who runs it.").

1067 The absolute priority rule is implicated when there is an undersecured creditor who rejects the debtor's plan. This undersecured creditor receives a lot of power in this circumstance because the creditor's claim is bifurcated such that the creditor is able to vote in the secured class *and* the unsecured class. The small business debtor likely has only a few classes of claims. This ultimately makes the plan very difficult to confirm under the cramdown provisions. *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

1068 The new value exception presents problems in small business cases because there may be tension between the oversecured creditor and the owner-operators (equity security holders). These equity security holders may give new value to retain some stake in the reorganized business. However, there may be challenges in appropriately applying the new value exception in small business cases. *Id.* at 2–6.

1069 *Id.* at 2. *See also Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) ("Inclusion of limited exclusivity and the implementation of the absolute priority rule in the bankruptcy regime make the most sense with respect to large public entities whose creditors and equity holders made informed investment decisions and understood their risk and relative priorities. I am not sure that the considerations are the same with respect to smaller businesses. Should entrepreneurs and families who are involved in the day to day operations of their businesses be provided some level of protection not available to holders of securities in public companies?"), *available at* Commission website, *supra* note 55.

1070 *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) (suggesting that small businesses that are managed by equity security holders delay filing because of the personal financial detriment that such filings will cause them), *available at* Commission website, *supra* note 55.

Plan Content and Confirmation in SME Cases: Recommendations and Findings

A debtor's emergence from chapter 11 frequently turns on its ability to confirm a chapter 11 plan. Although it may consider a sale of all or substantially all of its assets under section 363x as an exit strategy, a debtor — particularly an SME who likely has founders or managers as part of its prepetition ownership structure — strives to reorganize and emerge from chapter 11 as a stronger and more efficient version of its prepetition business.

The Commission considered at length the interests of an SME's prepetition stakeholders and the challenges to confirmable plans for SME debtors.[1071] The Commissioners acknowledged that many SMEs are family-owned businesses or businesses in which the founders are still actively involved.[1072] For this reason, many SMEs find the common result of plan confirmation extinguishing prepetition equity interests in their entirety unsatisfactory or completely unworkable. The Commissioners discussed the tension created by these expectations: prepetition equity views their contributions and continued participation as necessary to the reorganization, but stakeholders may hold a very different perspective. Prepetition equity or managers may be considered part of the problem or ineffective.

The Commissioners debated how best to mitigate this tension and foster a meaningful reorganization process for SMEs. Most Commissioners agreed that the SME principles should include some option for prepetition equity security holders to retain or receive the equity of the reorganized debtor, beyond that currently permitted under the new value corollary. These Commissioners asserted that SMEs needed a reorganization path that encouraged founders and prepetition equity not only to invoke chapter 11, but also to devote all of their efforts to the debtor's successful reorganization. Indeed, for many SMEs — whether stakeholders like them or not — the prepetition founders or managers often possess the knowhow and relationships necessary to facilitate a successful restructuring of the business.[1073]

The Commissioners determined that the SME principles should create an equity retention structure that would appropriately align the interests of prepetition management and equity with the debtor's reorganization and protect the interests of unsecured creditors, despite noncompliance with the traditional absolute priority rule. The basic elements of this structure include:

- A reorganized capital structure that (i) permits prepetition equity to retain or receive 100 percent of the voting interests in the reorganized debtor, subject to the limited voting rights of the creditors' preferred interests, and no more than 15 percent of the economic ownership interests in the reorganized debtor (akin to common stock ownership

1071 *See, e.g., Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–6 (Apr. 19, 2013) (discussing how the absolute priority rule and the new value exception create challenges in the bankruptcies of owner-operated small businesses), *available at* Commission website, *supra* note 55.

1072 *See, e.g., Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Nov. 3, 2012) ("While it is beneficial that value is being realized for creditors, the blood, sweat and tears of the owners are not being accorded the [appropriate] considerations [which affect the use of chapter 11 by small businesses]."), *available at* Commission website, *supra* note 55.

1073 *Written Statement of Maria Chavez-Ruark: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 7, 2012) ("[I]n smaller Chapter 11 proceedings the debtor's competitive advantage is [often] based on the owners' relationships with customers, suppliers or others."), *available at* Commission website, *supra* note 55.

with limited economic rights); and (ii) grants preferred ownership interests to general unsecured creditors that include limited voting rights on extraordinary transactions and at least 85 percent of the economic ownership interests in the reorganized debtor (creditors' preferred interests).

- A provision in the plan that directs the reorganized debtor to pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. This provision is intended to provide cash dividends to unsecured creditors prior to maturity of the preferred interests and to fairly allocate the reorganized debtor's excess cash to claims impaired by the chapter 11 plan.

- The creditors' preferred interests mature on the fourth anniversary of the effective date of the chapter 11 plan, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.

- The holders of creditors' preferred interests are entitled to vote on any and all of the following extraordinary transactions: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. This provision is intended to protect the value of, and entitlement to, the cash, creditors' preferred interests, and other distributions allocated to unsecured creditors under the plan from diminution or impairment by the postconfirmation actions of common interest-holders, managers, or insiders. The failure to adhere to the voting or other rights granted to holders of creditors' preferred interests under or in connection with the plan constitutes a default under the plan that may be enforced in the bankruptcy court. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.

- Finally, the prepetition equity must commit to support the plan, the debtor's emergence from chapter 11, and its postconfirmation operations.

The Commission voted to recommend an equity-retention plan structure built on these basic elements. It believed that such a structure will provide appropriate incentives and protections, basically giving prepetition equity security holders four years after confirmation to repay the business's prepetition unsecured creditors. If the prepetition equity security holders are not able to achieve this result in that time period, then the unsecured creditors may convert their preferred interests into common ownership interests, significantly diluting the common ownership held by the prepetition equity security holders. Under this structure, both prepetition equity security holders and unsecured creditors have incentives to foster a sustainable and profitable reorganized business.

Finally, the Commissioners recommended other modifications to the section 1129(a) confirmation standards, including a mandatory bifurcation of undersecured creditors' claims so that only the allowed secured claim of such creditor would be subject to the cramdown requirements of section 1129(b)(2)(A), and its unsecured deficiency claim would be subject to the treatment provided general unsecured creditors. In addition, certain other modifications proposed by these principles to plan confirmation requirements for all chapter 11 cases would apply to SME cases, such as the elimination of an accepting impaired class of creditors under section 1129(a)(10). Notably, the Commission did not recommend application of the redemption option value principles to SME cases.[1074]

1074 For a discussion of the redemption option value principles and the potential challenges to applying them in SME cases, see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.

LEW18575 S.L.C.

115TH CONGRESS
2D SESSION

S. ______

To amend chapter 11 of title 11, United States Code, to address reorganization of small businesses, and for other purposes.

IN THE SENATE OF THE UNITED STATES

Mr. GRASSLEY (for himself and Mr. WHITEHOUSE) introduced the following bill; which was read twice and referred to the Committee on

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A BILL

To amend chapter 11 of title 11, United States Code, to address reorganization of small businesses, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Small Business Reorganization Act of 2018".

SEC. 2. REORGANIZATION OF SMALL BUSINESS DEBTORS.

(a) IN GENERAL.—Chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SUBCHAPTER V—SMALL BUSINESS DEBTOR REORGANIZATION

"§ 1181. Inapplicability of other sections

"(a) IN GENERAL.—Sections 105(d), 1101(1), 1104, 1105, 1106, 1107, 1108, 1115, 1116, 1121, 1123(a)(8), 1123(c), 1127, 1129(a)(15), 1129(b), 1129(c), 1129(e) and 1141(d)(5) of this title do not apply in a case under this subchapter.

"(b) COURT AUTHORITY.—Unless the court for cause orders otherwise, paragraphs (1), (2), and (4) of section 1102(a) and sections 1102(b), 1103, and 1125 of this title do not apply in a case under this subchapter.

"(c) SPECIAL RULE FOR DISCHARGE.—If a plan is confirmed under section 1191(b) of this title, section 1141(d) of this title shall not apply, except as provided in section 1192 of this title.

"§ 1182. Definitions

"In this subchapter:

"(1) DEBTOR.—The term 'debtor' means a small business debtor.

"(2) DEBTOR IN POSSESSION.—The term 'debtor in possession' means the debtor, unless removed as debtor in possession under section 1185(a) of this title.

"§ 1183. Trustee

"(a) IN GENERAL.—If the United States trustee has appointed an individual under section 586(b) of title 28 to serve as standing trustee in cases under this subchapter, and if such individual qualifies as a trustee under section 322 of this title, then that individual shall serve as trustee in any case under this subchapter. Otherwise, the United States trustee shall appoint 1 disinterested person to serve as trustee in the case or the United States trustee may serve as trustee in the case, as necessary.

"(b) DUTIES.—The trustee shall—

"(1) perform the duties specified in paragraphs (2), (5), (6), (7), and (9) of section 704(a) of this title;

"(2) perform the duties specified in paragraphs (3), (4), and (7) of section 1106(a) of this title, if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

"(3) appear and be heard at the status conference under section 1188 of this title and any hearing that concerns—

"(A) the value of property subject to a lien;

"(B) confirmation of a plan filed under this subchapter;

"(C) modification of the plan after confirmation; or

"(D) the sale of property of the estate;

"(4) ensure that the debtor commences making timely payments required by a plan confirmed under this subchapter;

"(5) if the debtor ceases to be a debtor in possession, perform the duties specified in section 704(a)(8) and paragraphs (1), (2), and (6) of section 1106(a) of this title, including operating the business of the debtor;

"(6) if there is a claim for a domestic support obligation with respect to the debtor, perform the duties specified in section 704(c) of this title; and

"(7) facilitate the development of a consensual plan of reorganization.

"(c) TERMINATION OF TRUSTEE SERVICE.—

"(1) IN GENERAL.—If the plan of the debtor is confirmed under section 1191(a) of this title, the service of the trustee in the case shall terminate when the plan has been substantially consummated, except that the United States trustee may reappoint a trustee as needed for performance of duties under subsection (b)(3)(C) of this section and section 1185(a) of this title.

"(2) SERVICE OF NOTICE OF SUBSTANTIAL CONSUMMATION.—Not later than 14 days after the plan of the debtor is substantially consummated, the debtor shall file with the court and serve on the trustee, the United States trustee, and all parties in interest notice of such substantial consummation.

"§ 1184. Rights and powers of a debtor in possession

"Subject to such limitations or conditions as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all functions and duties, except the duties specified in paragraphs (2), (3), and (4) of section 1106(a) of this title, of a trustee serving in a case under this chapter, including operating the business of the debtor.

"§ 1185. Removal of debtor in possession

"(a) IN GENERAL.—On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under this subchapter.

"(b) REINSTATEMENT.—On request of a party in interest, and after notice and a hearing, the court may reinstate the debtor in possession.

"§ 1186. Property of the estate

"(a) INCLUSIONS.—If a plan is confirmed under section 1191(b) of this title, property of the estate includes, in addition to the property specified in section 541 of this title—

"(1) all property of the kind specified in that section that the debtor acquires after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first; and

"(2) earnings from services performed by the debtor after the date of commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 of this title, whichever occurs first.

"(b) DEBTOR REMAINING IN POSSESSION.—Except as provided in section 1185 of this title, a plan confirmed under this subchapter, or an order confirming a plan under this subchapter, the debtor shall remain in possession of all property of the estate.

"§ 1187. Duties and reporting requirements of debtors

"(a) FILING REQUIREMENTS.—Upon electing to be a debtor under this subchapter, the debtor shall file the documents required by subparagraphs (A) and (B) of section 1116(1) of this title.

"(b) OTHER APPLICABLE PROVISIONS.—A debtor, in addition to the duties provided in this title and as otherwise required by law, shall comply with the requirements of section 308 and paragraphs (2), (3), (4), (5), (6), and (7) of section 1116 of this title.

"(c) SEPARATE DISCLOSURE STATEMENT EXEMPTION.—If the court orders under section 1181(b) of this title that section 1125 of this title applies, section 1125(f) of this title shall apply.

"§ 1188. Status conference

"(a) IN GENERAL.—Except as provided in subsection (b), not later than 60 days after the entry of the order for relief under this chapter, the court shall hold a status conference to further the expeditious and economical resolution of a case under this subchapter.

"(b) EXCEPTION.—The court may extend the period of time for holding a status conference under subsection (a) if the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable.

"(c) REPORT.—Not later than 14 days before the date of the status conference under subsection (a), the debtor shall file with the court and serve on the trustee and all parties in interest a report that details the efforts the debtor has undertaken and will undertake to attain a consensual plan of reorganization.

"§ 1189. Filing of the plan

"(a) WHO MAY FILE A PLAN.—Only the debtor may file a plan under this subchapter.

"(b) DEADLINE.—The debtor shall file a plan not later than 90 days after the order for relief under this chapter, except that the court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable.

"§ 1190. Contents of plan

"A plan filed under this subchapter—

"(1) shall include—

"(A) a brief history of the business operations of the debtor;

"(B) a liquidation analysis; and

"(C) projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization;

"(2) shall provide for the submission of all or such portion of the future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan; and

"(3) notwithstanding section 1123(b)(5) of this title, may modify the rights of the holder of a secured claim if—

"(A) the claim is secured only by a security interest in real property that is the principal residence of the debtor; and

"(B) the new value received in connection with the granting of the security interest—

"(i) was not used primarily to acquire the real property; and

"(ii) was used primarily in connection with the small business of the debtor.

"§ 1191. Confirmation of plan

"(a) TERMS.—The court shall confirm a plan under this subchapter only if all of the requirements of section 1129(a), other than paragraph (15) of that section, of this title are met.

"(b) EXCEPTION.—Notwithstanding section 510(a) of this title, if all of the applicable requirements of section 1129(a) of this title, other than paragraphs (8), (10), and (15) of that section, are met with respect to a plan, the court, on request of the debtor, shall confirm the plan notwithstanding the requirements of such paragraphs if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

"(c) RULE OF CONSTRUCTION.—For purposes of this section, the condition that a plan be fair and equitable with respect to each class of claims or interests includes the following requirements:

"(1) With respect to a class of secured claims, the plan meets the requirements of section 1129(b)(2)(A) of this title.

"(2) As of the effective date of the plan—

"(A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or

"(B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

"(3)(A)(i) The debtor will be able to make all payments under the plan; or

"(ii) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and

"(B) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made.

"(d) DISPOSABLE INCOME.—For purposes of this section, the term 'disposable income' means the income that is received by the debtor and that is not reasonably necessary to be expended—

"(1) for—

"(A) the maintenance or support of the debtor or a dependent of the debtor; or

"(B) a domestic support obligation that first becomes payable after the date of the filing of the petition; or

"(2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor.

"(e) SPECIAL RULE.—Notwithstanding section 1129(a)(9)(A) of this title, a plan that provides for the payment through the plan of a claim of a kind specified in paragraph (2) or (3) of section 507(a) of this title may be confirmed under subsection (b) of this section.

"§ 1192. Discharge

"If the plan of the debtor is confirmed under section 1191(b) of this title, as soon as practicable after completion by the debtor of all payments due within the first 3 years of the plan, or such longer period not to exceed 5 years as the court may fix, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title, and all other debts allowed under section 503 of this title and provided for in the plan, except any debt—

"(1) on which the last payment is due after the first 3 years of the plan, or such other time not to exceed 5 years fixed by the court; or

"(2) of the kind specified in section 523(a) of this title.

"§ 1193. Modification of plan

"(a) MODIFICATION BEFORE CONFIRMATION.—The debtor may modify a plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. After the modification is filed with the court, the plan as modified becomes the plan.

"(b) MODIFICATION AFTER CONFIRMATION.—If a plan has been confirmed under section 1191(a) of this title, the debtor may modify the plan at any time after confirmation of the plan and before substantial consummation of the plan, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. The plan, as modified under this subsection, becomes the plan only if circumstances warrant the modification and the court, after notice and a hearing, confirms the plan as modified under section 1191(a) of this title.

"(c) CERTAIN OTHER MODIFICATIONS.—If a plan has been confirmed under section 1191(b) of this title, the debtor may modify the plan at any time within 3 years, or such longer time not to exceed 5 years, as fixed by the court, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1191(b) of this title. The plan as modified under this subsection becomes the plan only if circumstances warrant such modification and the court, after notice and a hearing, confirms such plan, as modified, under section 1191(b) of this title.

"(d) HOLDERS OF A CLAIM OR INTEREST.—If a plan has been confirmed under section 1191(a) of this title, any holder of a claim or interest that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless, within the time fixed by the court, such holder changes the previous acceptance or rejection of the holder.

"§ 1194. Payments

"(a) RETENTION AND DISTRIBUTION BY TRUSTEE.—Payments and funds received by the trustee shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan. If a plan is not confirmed, the trustee shall return any such payments to the debtor after deducting—

"(1) any unpaid claim allowed under section 503(b) of this title;

"(2) any payment made for the purpose of providing adequate protection of an interest in property due to the holder of a secured claim; and

"(3) any fee owing to the trustee.

"(b) OTHER PLANS.—If a plan is confirmed under section 1191(b) of this title, except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

"(c) PAYMENTS PRIOR TO CONFIRMATION.—Prior to confirmation of a plan, the court, after notice and a hearing, may authorize the trustee to make payments to the holder of a secured claim for the purpose of providing adequate protection of an interest in property.

"§ 1195. Transactions with professionals

"Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title, by a debtor solely because that person holds a claim of less than $10,000 that arose prior to commencement of the case.".

(b) CLERICAL AMENDMENT.—The table of subchapters at the beginning of chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SUBCHAPTER V—SMALL BUSINESS DEBTOR REORGANIZATION

"1181. Inapplicability of other sections.
"1182. Definitions.
"1183. Trustee.
"1184. Rights and powers of a debtor in possession.
"1185. Removal of debtor in possession.
"1186. Property of the estate.
"1187. Duties and reporting requirements of debtors.
"1188. Status conference.
"1189. Filing of the plan.
"1190. Contents of plan.
"1191. Confirmation of plan.
"1192. Discharge.

SEC. 3. PREFERENCES; VENUE OF CERTAIN PROCEEDINGS.

(a) PREFERENCES.—Section 547(b) of title 11, United States Code, is amended by inserting ", based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)," after "may".

(b) VENUE OF CERTAIN PROCEEDINGS.—Section 1409(b) of title 28, United States Code, is amended by striking "$10,000" and inserting "$25,000".

SEC. 4. CONFORMING AMENDMENTS.

(a) TITLE 11.—Title 11, United States Code, is amended—

(1) in section 101—

(A) in paragraph (51C), by inserting "and has not elected that subchapter V of chapter 11 of this title shall apply" after "is a small business debtor"; and

(B) in paragraph (51D)—

(i) in subparagraph (A)—

(I) by striking "or operating real property or activities incidental thereto" and inserting "single asset real estate"; and

(II) by striking "for a case in which" and all that follows and inserting "not less than 50 percent of which arose from the commercial or business activities of the debtor; and"; and

(ii) in subparagraph (B)—

(I) by striking the period at the end and inserting a semicolon;

(II) by striking "does not include any member" and inserting the following: "does not include—

"(i) any member"; and

(III) by adding at the end the following:

"(ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); or

"(iii) any corporation that—

"(I) is subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); and

"(II) is an affiliate of a debtor.";

(2) in section 103—

(A) by redesignating subsections (i) through (k) as subsections (j) through (l), respectively; and

(B) by inserting after subsection (h) the following:

"(i) Subchapter V of chapter 11 of this title applies only in a case under chapter 11 in which a small business debtor elects that subchapter V of chapter 11 shall apply.";

(3) in section 322(a), by inserting "1183," after "1163,";

(4) in section 326—

(A) in subsection (a), by inserting ", other than a case under subchapter V of chapter 11," after "7 or 11"; and

(B) in subsection (b), by inserting "subchapter V of chapter 11 or" after "In a case under";

(5) in section 347—

(A) in subsection (a)—

(i) by inserting "1194," after "726,"; and

(ii) by inserting "subchapter V of chapter 11," after "chapter 7,"; and

(B) in subsection (b), by inserting "1194," after "1173,";

(6) in section 363(c)(1), by inserting "1183, 1184," after "1108,";

(7) in section 364(a), by inserting "1183, 1184," after "1108,";

(8) in section 523(a), in the matter preceding paragraph (1), by inserting "1192," after "1141,";

(9) in section 524—

(A) in subsection (a)—

(i) in paragraph (1), by inserting "1192," after "1141,"; and

(ii) in paragraph (3), by inserting "1192," after "523,";

(B) in subsection (c)(1), by inserting "1192," after "1141,"; and

(C) in subsection (d), by inserting "1192," after "1141,";

(10) in section 557(d)(3), by inserting "1183," after "1104,";

(11) in section 1102(a), by striking paragraph (3) and inserting the following:

"(3) Unless the court for cause orders otherwise, a committee of creditors may not be appointed in a small business case or a case under subchapter V of this chapter.''; and

(12) in section 1146(a), by inserting ''or 1191'' after ''1129''.

(b) TITLE 28.—Title 28 United States Code, is amended—

(1) in section 586—

(A) in subsection (a)(3), by inserting ''(including subchapter V of chapter 11)'' after ''7, 11'';

(B) in subsection (b), by inserting ''subchapter V of chapter 11 or'' after ''cases under'';

(C) in subsection (d)(1), by inserting ''subchapter V of chapter 11 or'' after ''cases under'' each place that term appears; and

(D) in subsection (e)—

(i) in paragraph (1), by inserting ''subchapter V of chapter 11 or'' after ''cases under'';

(ii) in paragraph (2), by inserting ''subchapter V of chapter 11 or'' after ''cases under'' each place that term appears; and

(iii) by adding at the end the following:

"(5) In the event that the services of the trustee in a case under subchapter V of chapter 11 of title 11 are terminated by dismissal or conversion of the case, or upon substantial consummation of a plan under section 1183(c)(1) of that title, the court shall award compensation to the trustee consistent with services performed by the trustee and the limits on the compensation of the trustee established pursuant to paragraph (1) of this subsection.";

(2) in section 589b—

(A) in subsection (a)(1), by inserting "subchapter V of chapter 11 and" after "cases under"; and

(B) in subsection (d)—

(i) in the matter preceding paragraph (1), by inserting "subchapter V of chapter 11 and" after "trustees under"; and

(ii) in the undesignated matter following paragraph (8), by inserting "subchapter V of chapter 11 and" after "cases under"; and

(3) in section 1930(a)(6)(A), by inserting ", other than under subchapter V," after "chapter 11 of title 11".

SEC. 5. EFFECTIVE DATE.

This Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act.