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Dealing with the Under-Funded Chapter 11 Debtor

by
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United States Bankruptcy Court
Tampa, Florida

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I. The Creditor's Response to Pre-Petition Requests for a Carve-Out for Professionals or Unsecured Creditors and the Use of Cash Collateral

1. *The Practical and Legal Issue: Running a Case Just for the Secured Creditor's Benefit?*

   a) As a result of the global recession and meltdown in property values, an increasing number of severely distressed businesses are filing Chapter 11 petitions.

   b) When the secured lender is so completely underwater, unsecured creditors and the committees that represent their interests are finding that they have virtually no hope of recovery after the secured creditors are paid.

   c) Moreover, when continuing the case in bankruptcy does not advance the purposes of a Chapter 11 reorganization, then why shouldn't a secured creditor simply pursue its remedies in state court?

   d) If the bankruptcy case is being run then just for the benefit of the secured creditor, it begs the question, must the secured creditor fund or "carve-out" a portion of its collateral proceeds to keep the case in bankruptcy? In other words, must the secured creditor "pay to play?"

      (i) Must it create a carve-out for professional fees?

      (ii) Must it create a carve-out for unsecured creditors?

2. *"Carve-Outs" in Chapter 11 Cases: Protecting the Integrity of the Reorganization Process or Disrespecting the Code's Distribution Requirements?*

   a) Carve-Outs for Professional Fees

      (i) Historically, it has been quite common for a secured creditor to set aside or "carve out" a part of the proceeds from its collateral to pay debtor's counsel, creditor's committee counsel, and other professionals.

1. Public policy considerations have driven courts to require such payments. Absent a professional fee carve-out, "the ability of anyone to investigate potential preference, fraudulent conveyance, lender liability, and the claims of the estate would be lost." Andrew L. Turscak, Jr. & Alan R. Lepene, *Must a Secured Creditor "Pay to Play" in Chapter 11?"*, 28 Am. Bankr. Inst. J. 36, 36 (Mar. 2009).

2. The funding of professional services to investigate disputes or conflicts with the secured creditor may be essential to maintaining the integrity of the bankruptcy estate, especially where DIP financing is sought. *Id.* at n.5 (signaling *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 38 (Bankr. S.D. N.Y. 1990) (noting its practice to require professional fee carve-outs "in reasonable amounts" from a super-priority status and post-petition lien "to preserve the adversary system" and protect "the rights and expectations of all parties-in-interest")).

(ii) Recently, lenders have been increasingly "unwilling to grant any sharing of a 'carve-out' under cash collateral authorization and/or postpetition financing arrangements" with committee counsel and, and in some cases, debtor's professionals. Joshua Klein, Esq., *Creditor Committees in "Meltdown" Chapter 11 Cases"*, 26 Bankr. Strategist 1 (Oct. 2009).

(iii) Any "disparate treatment" of professional fees, however, may create statutory conflicts that preclude Chapter 11 relief.

1. § 1103(c) of the Bankruptcy Code charges a creditor committee "with the duty to conduct the appropriate investigation of the debtor's affairs and its relationship with its lender." *Id.* Thus, a lender's unwillingness to grant any professional fee carve-out for committee counsel may prevent the committee "from carrying out its statutory duties." *Id.*

2. When a Chapter 11 Case is converted to a Chapter 7 (a common scenario after a § 363 sale of all assets), allowing debtor's counsel fees and expenses while not allowing for similar payment to committee counsel may violate § 726(b), which requires equality of distribution among claimants in each class. *Id.* (citing *In re Specker Motor Sales, Co.*, 289 B.R. 870, 872 (Bankr. W.D. Mich. 2003)).

   a) "[T]o allow Debtor's counsel to collect more than the other administrative claimants is a violation of the equality of distribution required under 11 U.S.C. § 726(b). There is no priority among administrative claimants." *Specker*, 289 B.R. at 872 (emphasis added) (citing *In re Grigg Clothing Co.,* 62 B.R. 1016 (Bankr. D. S.D. 1986)).

   b) The appropriate remedy in such a case is to order disgorgement of all interim compensation necessary to achieve § 726(b)'s "pro rata disbursement" requirement. *Specker*, 289 B.R. at 872.

(iv) Thus, when the risk of a secured creditor "not paying" professional fees threatens the integrity of the bankruptcy process itself, the creditor must be willing to "pay to play."

b) Carve-Outs or "Gifting" for Unsecured Creditors

(i) When a case is being run just for the benefit of a secured creditor, some argue that a carve-out payment for unsecured creditors is required so that the lender bears some cost while reaping the benefits of keeping the case in bankruptcy.

(ii) The presence of such a carve-out, however, can also create distribution priority issues.

1. In a Chapter 11 case, creditors who actively challenge a plan's confirmation wield tremendous bargaining power in their ability to delay confirmation.

2. This power can arguably be utilized disproportionately, especially where the challenge is raised by a creditor who appears "out of the money." It is particularly bothersome when the debtor and senior creditors desire an early § 363 sale.

3. Therefore, *out of practical considerations*, many debtors and senior creditors have resorted to creative methods to avoid a contentious confirmation hearing or to ensure a smooth and quick approval of their § 363 sale.

4. One such method is commonly known as "gifting"—i.e., when a senior creditor negotiates to transfer some of the value it will receive from the proceeds of its secured collateral (i.e., from the bankruptcy estate) to a more junior class of creditors.

5. Most commonly, it is a senior, secured creditor who "gifts" a nominal distribution to an unsecured creditor or equity class that otherwise would have no hope of recovery from the bankruptcy estate.

(iii) If a secured creditor thus chooses to pay to play via gifting, the resulting legal issue for the court is "whether the secured creditor *can or should be allowed to play* using such a method?"

1. Specifically, a court must evaluate whether the transfer of a secured creditor's collateral is being gifted in derogation of the Bankruptcy Code's statutorily proscribed distribution priorities such as the absolute priority rule.

2. Each gifting case must be evaluated on its own set of facts and circumstances, and most commentators believe that the issue is far from

(iv) The Evolution of "Gifting" Cases

1. *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993) – An agreement between the Chapter 7 secured lender and the creditors' committee for the lender to share part of its distribution with the unsecured creditors *was* enforceable despite the debtor's inability to pay the intervening class (i.e., the priority tax creditors) in full.

   Reasoning: Because the secured creditor had a total asset lien and the priority tax claimants were not entitled to any distributions, the agreement did "not distribute property of the estate 'at the expense of' [the] priority [tax] creditors" and did not violate the bankruptcy priority scheme. 984 F.2d at 1313. Moreover, "[w]hile the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors, *see King v. United States,* 379 U.S. 329 (1964), creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."

2. *In re Armstrong World Industr. Inc.*, 432 F.3d 507 (3d Cir. 2005) – Chapter 11 plan that automatically distributed stock warrants from a class of junior creditors to shareholders over the objection of an impaired class violated the plain language of § 1129(b)(2)(B)—the absolute priority rule—and could not be confirmed.

   Reasoning: *SPM Manufacturing* was distinguishable in that *SPM* was a Chapter 7 case and did not trigger § 1129(b)(2)(B)(ii). Moreover, it is not an "unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive. Creditors must also be guided by the statutory prohibitions of the absolute priority rule." 432 F.3d at 514. Whatever mechanism put the stock warrants in the hands of the equity interest holders, at the end of the day, those equity holders received value in excess of what an objecting class of unsecured creditors would receive under the plan—i.e., a bottom-line violation of the absolute priority rule.

3. *In re World Health Alternatives*, 344 B.R. 291 (Bankr. D. Del. 2006) – Chapter 11 debtor brought a first-day § 363 sale motion proposing to sell all assets to the pre-petition lender for $43 million under a previously negotiated "stalking-horse" asset purchase agreement. After negotiations with the unsecured creditors committee that objected, the lender 1) capped its claim at $42 million and 2) carved out a $1.625 million payment to general unsecured creditors after payment of the committee's unpaid professional fees. The U.S. Trustee objected that this violated the underlying policy of *In re Armstrong* because it provided funds to the unsecured creditors without first paying senior priority claims such as $4

Reasoning: The bankruptcy court first found that, like *SPM Manufacturing* and unlike *Armstrong*, the dispute arose in the context of a settlement agreement, and not a Chapter 11 plan, and there were "no prospects for a plan of reorganization." *World Health*, 344 B.R. at 298. Thus, the absolute priority rule of § 1129(b)(2)(B) was not triggered. *Id.* Second, like *SPM Manufacturing* and unlike *Armstrong,* the secured lender had a perfected security interest, and that property interest "was not subject to distribution under the Bankruptcy Code's priority scheme." *Id.* (quoting *Armstrong*, 432 F.3d at 514). Thus, the secured lender could give a portion of the collateral proceeds to a junior class of creditors without violating § 507 or § 726.

(v) Lessons from the "Gifting" Cases

1. When a court has approved a gifting carve-out, the parties advocating this treatment have successfully:

   a) characterized the portion of the secured lender's collateral to be transferred as not property of the bankruptcy estate, thus bypassing the Bankruptcy Code's distribution and priority requirements, and

   b) presented the transfer as part of a proposed settlement in the best interest of the estate rather than part of a reorganization plan.

2. Though many generally identify a gift or redistribution of assets from a senior class of creditors to a more junior class as "a violation of the absolute priority rule," this general and non-specific language is misleading.

   a) Technically, the absolute priority rule codified in§ 1129(b)(2)(B) does not prohibit all distributions at any time to any lower class over the interest and objection of an intervening class.

   b) Instead, this section addresses whether, in the context of cramdown, a proposed plan is fair and equitable to an impaired class of unsecured creditors.

   c) The section prohibits distributions (1) under a plan, (2) to a class lower than a class of unsecured claims, (3) when that unsecured creditor class is impaired.

3. Proposed gifting distributions to unsecured creditors can still violate the Bankruptcy Code's priority distribution scheme under §§ 503, 507, and 1129(a)(7)-(9), however, if those distributions are made "at the expense of higher, impaired claims such as priority claims and administrative claims

II. Propriety of First-Day Motions to Dismiss Under § 1112(b)(4)(A)

1. *Dismissal for cause for "the substantial or continuing loss or diminution of the estate and the absence of a reasonable likelihood of rehabilitation."*

   a) Under § 1112(b)(1), "a court *shall* dismiss a Chapter 11 case or convert it to a Chapter 7 if a movant can establish cause." (Emphasis added). (Note: BAPCPA reduced a bankruptcy court's discretionary power to dismiss or convert when it replaced the word "may" with "shall" in § 1112(b)(1)).

   b) Under § 1112(b)(4)(A), cause includes:

      (i) "a substantial or continuing loss to or dimunition of the estate AND"

      (ii) "the absence of a reasonable likelihood of rehabilitation"

   c) *Collier's* describes the two-pronged requirement as:

      (i) "whether, after the commencement of the case, the debtor has suffered or continued to experience a negative cash flow, or, alternatively, declining asset values." 7 *Collier's on Bankruptcy* § 1112.04[5][a] (rev'd. 2005)

      (ii) "whether there is any reasonable likelihood that the debtor, or some other party, will be able to stem the debtor's losses and place the debtor's business enterprise back on a solid financial footing within a reasonable amount of time" *Id.*

   d) Bad-Faith Filings

      (i) While the list of reasons enumerated in 1112(b)—i.e., reasons for which a court may dismiss or convert a case "for cause"—is not exhaustive, no provision of the Code expressly authorizes a court to dismiss a case based on bad faith, or a lack of good faith.

         1. Instead, "the Bankruptcy Code *implicitly* requires a person filing a Chapter 11 petition to do so only in good faith." *In re New Towne Development, LLC*, 404 B.R. 140, 146 (Bankr. M.D. La. 2009) (emphasis added).

      (ii) *In re Albany Partners*, 749 F.2d 670, 674 (11th Cir. 1984) – the lack of a possibility of reorganization may constitute (or at least contribute to) cause to dismiss:

         "The equitable nature of this determination supports the construction that a debtor's lack of 'good faith' may constitute cause for dismissal of a petition. In finding a lack of good

> faith, courts have emphasized an intent to abuse the judicial process and the purposes of the reorganization provisions. Particularly when there is no realistic possibility of an effective reorganization and it is evident that the debtor seeks merely to delay or frustrate the legitimate efforts of secured creditors to enforce their rights, dismissal of the petition for lack of good faith is appropriate." *Id.* at 674 (emphasis added).

(iii) *In re Phoenix Piccadilly*, 849 F.2d 1393, 1394-95 (11th Cir. 1988) – the prospect of reorganization was not a factor, or at least not a positive factor.

> While there is "no particular test for determining whether a debtor has filed a petition in bad faith[,] . . . courts may consider any factors which evidence 'an intent to abuse the judicial process and the purposes of the reorganization provisions' or, in particular, factors which evidence that the petition was filed 'to delay or frustrate the legitimate efforts of secured creditors to enforce their rights.' " *Id.* at 1394-95 (quoting *Albany Partners*, 849 F.2d at 674).

The Court went on to articulate what has become known as the *Phoenix Piccadilly Factors* in support of its finding of bad faith:

1. The Debtor has only one asset, the Property, in which it does not hold legal title;
2. The Debtor has few unsecured creditors whose claims are small in relation to the claims of the Secured Creditors;
3. The Debtor has few employees;
4. The Property is the subject of a foreclosure action as a result of arrearages on the debt;
5. The Debtor's financial problems involve essentially a dispute between the Debtor and the Secured Creditors that can be resolved in the pending State Court Action; and
6. The timing of the Debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the Debtor's secured creditors to enforce their rights.

Significantly, the Eleventh Circuit noted that "[t]he possibility of a successful reorganization *cannot* transform a bad faith filing into one undertaken in good faith." *Id.* at 1395 (emphasis added).

As Judge Queenan has noted, the prospect of reorganization is "conspicuously absent" from *Phoenix Piccadilly's* list of factors. *In re Victoria Limited Partnership*, 187 B.R. 54, 59 (Bankr. D. Mass. 1995). He claims that "*Phoenix Piccadilly* stands for the startling proposition that it is an act of bad faith for the debtor to file under chapter 11 in order to prevent foreclosure upon its only asset." *Id.*

e) Single Asset Real Estate ("SARE") Cases

(i) Defined in 11 U.S.C. § 101(51B).

(ii) "Three requirements . . . must all be met for a debtor to be considered a SARE debtor: (1) the debtor must have real property constituting a single property or project (other than residential real property with fewer than 4 residential units), (2) which generates substantially all of the gross income of the debtor, and (3) on which no substantial business is conducted other than the business of operating the real property and activities incidental thereto. If a debtor fails to meet any prong, it is not a SARE." *In re Scotia Pacific Co., LLC*, 508 F.3d 214, 220 (5th Cir. 2007).

f) The Safe Harbor Provision of § 362(d)(3)

(i) Under § 362(d)(3), relief from the automatic stay will be granted, *unless*:

"within thirty days of the determination that [a] Chapter 11 case is a 'single asset real estate case,' [1] the Debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time *or* [2] has commenced monthly payments to the Movants [for relief] equal to the interest at the nondefault contract rate." *In re Webb MTN, LLC*, 2008 WL 656271 *6 (Bankr. E.D. Tenn. 2008) (emphasis added) (not reported).

(ii) § 362(d)(3)(A) utilizes the language "filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time." (Emphasis added.) This is very similar to the language in § 1112(b)(4)(A) that defines cause for dismissal or conversion under the second prong as "the absence of a reasonable likelihood of rehabilitation."

g) Does Bad Faith ≠ Bad Faith when a Debtor Can Find a Safe Harbor?

(i) *Phoenix Piccadilly* clearly stated that "[t]he possibility of a successful reorganization *cannot* transform a bad faith filing into one undertaken in good faith." 849 F.2d at 1395 (emphasis added).

(ii) The second method for finding a safe harbor under § 362(d)(3)(A), however, identifies the filing of a reasonably confirmable plan as one way to remain under the protection of the automatic stay.

(iii) Does this mean that the Safe Harbor Provision prevents a Court from finding bad faith when a debtor files a reasonably confirmable plan?

III. Evidentiary Issues Connected with Evidence of Debtor's Pre-Petition Financial Performance

1. *Evaluate the Decision to File: Is Reorganization Likely or Even Possible?*

   a) Type of Debtor –

      (i) A debtor's prospects for reorganization may depend in large part on the type of business in which the debtor is engaged.

         For example: real estate developers, manufacturing companies, and farmers[1] all face different challenges.

      (ii) Evaluate the global market conditions and issues that any similarly situated business would face (e.g., interest rates, depressed property values, market competition, market forces "upstream" from the debtor).

   b) Type of Problem -

      (i) Why is this debtor filing Chapter 11?

         1. Is the problem correctable?

         2. Was it a one-time event beyond the debtor's control?

      (ii) Look behind the "ready excuses" of the economy, recession, lending problems, etc. to identify the real causes.

         1. Bad management?

         2. Insufficient capitalization?

         3. Will the debtor's future prospects in this market improve, or are the debtor's days numbered?

   c) Financial Structure

      (i) To get a clear picture of the debtor's financial problems, you MUST "reconstruct" the balance sheet and income/expense statement.

      (ii) DON'T rely upon the existing balance sheet.

         1. The values are not relevant where they reflect the cost basis for inventory, the full value for accounts receivable with no reduction for doubtful accounts, etc.

[1] Note that in cases affecting farmers, subject to certain debt limitations, the pro-debtor provisions of Chapter 12 may be available.

2. Identify realistic (and not optimistic) liquidation values.

(iii) Review income and expenses.

1. Start with DIRECT and NECESSARY expenses such as C.O.D. purchases of inventory, power, payroll, etc.

2. Be wary of optimistic income projections – scrutinize carefully!

3. Evaluate the options.

a) Is there a possibility of closing unprofitable offices, reducing overhead, etc.?

b) What expenses are "fixed" at least for the short term? Which expenses can be eliminated immediately, and which resources can be reallocated?

(iv) If there is no funds or income left after payment of necessary expenses, then there will be nothing left to provide adequate protection payments to secured lenders and lessors, much less fund a reorganization plan.

d) <u>Debtor Motivation</u>

(i) Was the Chapter 11 filing prompted by shareholders' personal concerns that may have a bearing on the decisions made during the Chapter 11 case?

For example, if the responsible controlling shareholder is faced with substantial withholding tax penalties, the debtor may be motivated to file Chapter 11 and continue the case much longer than would be warranted if the debtor took a more realistic view.

(ii) Are there third-party guarantors (e.g., shareholders and their spouses) that might be involved and have an influence on the case?

(iii) Both of these situations may cause the principals to file and continue a Chapter 11 case when there is no realistic chance of successfully reorganizing.

e) <u>Debtor's Tentative Plan for Reorganization</u>

(i) Typically, debtors rush into Chapter 11 without giving much thought to how the reorganization will be carried out.

(ii) YOU must explore with the debtor the feasibility of reorganization. Generally speaking,

1. New capital and new management = good prospect for reorganization

2. "Business as Usual" = poor odds for a successful reorganization

2. *Discovery Strategy*

   a) Rule 9014 – **Contested Matters**

      (i) Rule 9014(d) - **Testimony of witnesses**. Testimony of witnesses with respect to disputed material factual issues shall be taken *in the same manner as testimony in an adversary proceeding*. (Emphasis added).

      (ii) Rule 9014(e) - **Attendance of witnesses**. The court shall provide procedures that enable parties to ascertain at a reasonable time before any scheduled hearing whether the hearing will be an evidentiary hearing at which witnesses may testify.

   b) Rule 7036 - **Requests for Admission** - Rule 36 F.R.Civ.P. applies in adversary proceedings.

   c) Rule 7034 - **Production of Documents and Things and Entry Upon Land for Inspection and Other Purposes** - Rule 34 F.R.Civ.P. applies in adversary proceedings.

3. *Evidence of Enterprise value as relevant to "likelihood of rehabilitation"*

   a) Business Records – Federal Rule of Evidence 803(6) – *The Business Record Exception to the Hearsay Rule*

      (i) The exhibit being offered is a business record;

      (ii) It is a record of an event;

      (iii) The record was made by, or from information transmitted by, a person with knowledge of the transaction recorded;

      (iv) The record was made at or near the time of the acts or event recorded;

      (v) The record is kept in the course of a regularly conducted business activity; and

      (vi) It was the regular practice of that business activity to make the record.

   b) Summaries - Federal Rule of Evidence 1006

      "The contents of voluminous writings, recordings, or photographs which cannot conveniently be examined in court *may* be presented in the form of a chart, summary, or calculation. The originals, or duplicates, *shall* be made available for examination or copying, or both, by other parties at reasonable time and place. The court *may* order that they be produced in court." (Emphasis added.)

c) Expert Opinion Testimony - *Daubert*[2]

(i) The Judge's Role as a *Gatekeeper*

(ii) "*Daubert for Dummies"*

1. Fed R. Evid. 702 - If expert knowledge "will assist the trier of fact to understand the evidence or to determine a fact in issue," a qualified expert *may* testify in the form of an opinion, if:

   a) the testimony is based upon sufficient facts or data,

   b) the testimony is the product of reliable principles and methods, and

   c) the witness has applied the principles and methods reliably to the facts of the case.

2. Qualification of the Expert Witness Is Not the Focus of *Daubert*

(iii) *Daubert* in Practice

1. The following is an all-too-common example of the direct examination of an expert on automobile value. (The context is the debtor's motion to determine the secured status of a creditor's claim that is secured by a lien on the debtor's automobile.) Here's how the testimony goes:

Debtor's Counsel: "Your Honor, I call Joseph Perrilli to the witness stand."

Debtor's Counsel: "Mr. Perrilli, what experience do you have in the valuation of automobiles?"

Witness: "I've been in the car business for 40 years. During that time, I've bought and sold in the neighborhood of 10,000 cars."

Debtor's Counsel: "At my request, did you perform an appraisal of the Debtor's 1997 Ford Taurus?"

Witness: "Yes, I did."

Debtor's Counsel: "Based on your years of experience in buying and selling automobiles, were you able to form an opinion as to its value?"

Witness: "Yes, I was. In my opinion it has a fair market value of $9,700."

Debtor's Counsel: "Thank you, Mr. Pirrelli. Your Honor, no further questions."

[2] *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 113 S. Ct. 2786 (1993).

2. This testimony FAILS to meet the criteria of Rule 702!

3. Specifically, there is no evidence as to the types of data Mr. Perrilli relied upon for his opinion. Examples of such data might include:

   a) anecdotal experience of the witness or others that the witness has consulted with concerning sales of similar automobiles,

   b) market reports and commercial publications generally used and relied upon by the persons in the business of buying and selling used cars,

   c) local auto auction reports, and advertisements.

d) Practical Pointers for Hearings

(i) Trial Binders –

1. Use them. They're both essential and invaluable.

2. Make them early, beginning with discovery.

3. Get your office staff engaged in the process of automatically creating these binders for all hearings. It will help get YOU organized.

4. There's no right or perfect way, just make sure to create a system of organization that makes sense to you.

5. Have a separate binder for witnesses.

(ii) Exhibits –

1. Keep them simple and easy to understand.

2. Recognize that, to the extent your opponent has not seen the information contained in an exhibit before, a court will sustain an objection to your exhibit if its admission prejudices your opponent.

3. Prepare in advance how your exhibits will be presented and what your needs will be in the courtroom (e.g., easel, projector, etc.)

4. "Warm" exhibits (i.e., those right out of the printer) are a recipe for disaster.

5. Even if not required by the rule, distribute during the hearing copies of an exhibit (or at least the relevant portions of an exhibit) for the Court, the Deputy Clerk, opposing counsel, and the witness.

6. Check your local rules for standards and requirements for marking exhibits.

IV. Use of Small Business Provisions: §§ 308 & 1116 – Reporting Requirements & Duties

Several provisions in the Bankruptcy Code are designed to afford small businesses a faster, more efficient, and less expensive mechanism for reorganizing their businesses. The benefits include:

- Combined hearings
- Avoidance of the creditor committee requirements, and
- Exclusivity periods during which only the debtor may file a plan.

Yet there are certain requirements the small business debtor must meet in order to receive this relief and rules that must be followed.[3]

1. *Requirements Imposed by the Bankruptcy Code for The Small Business Case*

   a) § 101(51C) and (51D) - Small Business Defined

      (i) A small business debtor is generally defined by the Bankruptcy Code as a person;

         1. engaged in "commercial or business activities," not including a person that primarily owns or operates real property,
         2. that has aggregate non-contingent liquidated secured and unsecured debts that do not exceed $2,190,000,
         3. which has no active, effective creditor committee at the time.[4]

      (ii) Prior to BAPCPA, small business treatment was discretionary, and the Code provided for an election to receive this treatment.

      (iii) Post BAPCPA, the controlling definitions of the "small business case" and a "small business debtor" mandate small business treatment.

   b) § 308 - Increased Debtor Reporting Requirements

      (i) The general administrative reporting requirements of §1116 (see below) were augmented under BAPCPA for the small business case by §308. This section does not apply to all debtors - the operative language is found under subsection (b) and applies only to the small business debtor.

      (ii) This section requires the filing of periodic reports addressing:

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[3] *See generally* George H. Singer, *The New Rules of Bankruptcy for Chapter 11 Business Reorganizations Under the B.A.P.C.P.A.*, 28 Cal. Bankr. J. 194, 226 (2006); Robert M. Lawless, *Small Business and the 2005 Bankruptcy Law: Should Mom and Apple Pie Be Worried?*, 31 S. Ill. U. L. J. 585-619 (2007).

[4] Bankruptcy Rule 1020(c): "the case shall proceed as a small business case only if… the court enters an order determining that the committee has not been sufficiently active or representative to provide effective oversight."

1. Profitability, cash receipts and disbursements, the status of post-petition tax returns, tax payments, and administrative expense payments.

2. The report must also include financial performance projections and a comparison of actual performance to prior projections, and it must indicate whether the debtor is in compliance with all post-petition requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure.

3. If shortcomings are reported, the debtor must report "how, at what cost, and when" they will be remedied.

(iii) § 308(b)(4)(C) requires, somewhat vaguely, that the small business debtor file a periodic report regarding "such other matters as are in the best interest of the debtor and creditors, and in the public interest in fair and efficient procedures under Chapter 11 of this title."

c) § 362(n) - Automatic Stay Provisions Related to the Small Business Case

(i) BAPCPA added another rule specifically directed toward the small business case so that the automatic stay would not protect the "serial" Chapter 11 filer. Thus, the automatic stay of § 362(a) will *not* apply in cases in which the debtor:

1. is a debtor in a small business case pending at the time the petition is filed; [and]
2. was a debtor in a small business case that was dismissed within two years before the date of the order for relief in the present case; [or]
3. was a debtor in a previous small business case where a plan was confirmed within two years before the order for relief in the present case; [or]
4. is an entity that acquired substantially all of the assets or business of an entity that is a small business debtor in a current case or was a small business debtor within two years before the present case unless the new entity establishes by a "preponderance of the evidence" that it "acquired substantially of all of the assets or business of such small business debtor in good faith and not for the purpose of evading this paragraph."

(ii) § 362(n)(2) provides certain exemptions from the above exclusions (i.e., meaning that the automatic stay *would* apply), including some certain involuntary cases.

(iii) But what about the Chapter 11 debtor with a confirmed plan that then faces financial difficulties? Does this rule out Chapter 7 dissolution? Would this be possible without creditor assistance? Would it require an involuntary petition? A re-opening of the case?

d) § 1102(a)(3) - Committees for the Small Business Debtor Case

(i) In a small business case, the appointment of a creditors' committee is *not* mandatory. This greatly reduces the administrative expenses for the small business debtor:

- "*On request* of a party in interest in a case in which the debtor is a small business debtor *and for cause*, the court *may* order that a committee of creditors not be appointed." 11 U.S.C.A. § 1102(a)(3) (emphasis added).

e) § 1116 - Duties of Debtor in Possession in the Small Business Case

(i) Code §1116 imposes incremental duties on the small business DIP not required of other Chapter 11 debtors, beginning with the filing of the petition. Some of the requirements of § 1116 are duplicative of other requirements typically imposed by local rule, but BAPCPA makes them explicit for small business debtors only.

(ii) In addition to more filing requirements, the small business debtor must also "attend, through its senior management" and counsel, any meetings scheduled by the court or the U.S. Trustee, "including initial debtor interviews, scheduling conferences, and meetings of creditors." § 1116(2).

f) §§ 1121(e), 1129(e) - Timing for Submitting & Confirming a Small Business Plan

(i) Section 1121(e) gives the debtor a 180-day exclusivity period within which to file a plan.

(ii) After the 180 days are up, the debtor and other parties in interest have a further 120 days in which to file a plan.

(iii) After 300 days, no plans may be filed.

(iv) Under § 1129(e), the Court *shall confirm* a plan in a small business case filed within the deadline set under § 1121(e) and in compliance with the provisions of Chapter 11 "not later than 45 days after the plan is filed" unless extended under the strict rules of 1121(e).

1. The use of the word "shall" strips the court of much of its discretion to determine timing.

(v) Extensions of Time: Several deadlines can be extended, as long as a debtor complies with the requirements of § 1121(e)(3), which requires a demonstration that "the court will [likely] confirm a plan within a reasonable period of time." § 1121(e)(3)(A). Further, for any extension of time,

1. A new deadline" must be imposed, and

2. The order granting the extension has to be "*signed before* the existing deadline has expired." § 1121(e)(3)(B) & (C) (emphasis added).

2. *Requirements Imposed by the Bankruptcy Rules for Small Business Cases*

a) Rule 1020 - Small Business Designation Requirements –

(i) Rule 1020 requires that the small business debtor indicate in the petition for relief (or within 15 days after entry of the order for relief in involuntary cases), whether it meets the statutory definition of a "small business debtor."

(ii) After this designation, the United States Trustee and other parties in interest have the opportunity to object to the designation within certain time frames.

(iii) Problems may arise for the debtor who declares small business status, and attempts to later change that status. *See In re Save Our Springs (S.O.S.) Alliance, Inc.*, 393 B.R. 452, 463 (Bankr. W.D. Tex. 2008) (at late stage of heavily expedited case, small business debtor was judicially and equitably estopped from changing small business status.)[5]

b) Rule 2015(a)(6) - Duty to Keep Records, Make Reports, and Give Notice of Case or Change of Status

(i) The small business DIP is in the position of a fiduciary, with the rights and powers of a Chapter 11 trustee, along with many of the duties. These duties include filing informational reports as required by §308 (see above).

(ii) Rule 2015(a)(6) provides that unless the court, for cause, sets another reporting period, the small business debtor must file the monthly reports required by §308 according to strict time deadlines.

1. The court, pursuant to Rule 9006(b)(1) of the Federal Rules of Bankruptcy Procedure, has discretion, for cause shown, to enlarge the time for filing monthly reports required by Rule 2015(a)(6).

(iii) Official Form 25C the "Small Business Monthly Operating Report" was designed with the active participation of the United States Trustee Program so that the Official Form would include all of the information that the United States Trustee reasonably needs to administer the case while also including all the information required by § 308. This avoids the need for filing separate forms and should limit the cost to the debtor and the bankruptcy estate.

c) Rule 3016(d) - Filing of Plan and Disclosure Statement in a Chapter 11 Reorganization Case

[5] For a list of recent cases dealing with small business requirements, see Supplemental Handout for "*Individual and Small Business Debtors in Chapter 11*," at http://www.curtislaw.net/sbdsupplement.pdf.

(i) The disclosure statement is a document that must contain information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization. 11 U.S.C. § 1125. The information required is governed by judicial discretion and the circumstances of the case.

(ii) Rule 3016(d) acknowledges that, under Revised Code § 1125(f)(1), if a plan in a small business case provides adequate information, the court may find that a separate disclosure statement is unnecessary.

d) Rule 3017.1 - Court Consideration of Disclosure Statement in a Small Business Case

(i) This rule was added to implement § 1125(f) permitting the court to *conditionally* approve a disclosure statement subject to final approval after notice and a hearing.

(ii) If a disclosure statement is conditionally approved, and no timely objection to the disclosure statement is filed, it is not necessary for the court to hold a hearing on final approval.

e) Rule 9006(b) - Enlargement of Time Periods

(i) On December 1, 2009, changes to Federal Statutes, Federal Rules of Bankruptcy Procedure, and Local Rules effected several changes to time period rules.

1. The underlying conceptual change was to adopt a "days are days" approach to counting time, as opposed to the former practice of excluding intervening weekends and holidays from periods of less than eight days.

2. Many rules are affected by this change. Generally,

a) 5-day periods become 7-day periods

b) 10-day periods become 14-day periods

c) 15-day periods become 14-day periods

d) 20-day periods become 21-day periods

e) 25-day periods become 28-day periods

3. No changes were made to rules with deadlines of less than 5 days.

3. *Fast Track Template*

a) The “fast track” was aimed at making Chapter 11 bankruptcy more feasible for small businesses by accelerating the normal timetables.

b) The use of fast track procedures in bankruptcy was pioneered in the mid 1980's by the Hon. A. Thomas Small, Chief Bankruptcy Judge for the Eastern District of North Carolina.

c) Judge Small's fast track involves three simple procedures:[6]

   (i) a combined hearing on the disclosure statement and plan confirmation,

   (ii) requiring early filing of the plan, and

   (iii) conditional approval of the disclosure statement.

d) A 2008 survey of the National Association of Credit Management on the use of fast-track provisions showed that the fast track provisions *have largely gone unused*.

   (i) 95.1% of the respondents have not dealt with a debtor going through the provisions, while only 4.9% had dealt with a fast track debtor.[7]

e) Combining hearings on the Disclosure Statement and Plan

   (i) "The hearing on approval of the disclosure statement *may* be combined with the hearing on confirmation of the plan." § 105 (d)(2)(b)(vi) (emphasis added).

   (ii) § 1125(f) - allows the court to conditionally approve the sufficiency of a debtor's disclosure statement without notice and avoid a disclosure statement hearing by combining the disclosure statement hearing with the confirmation hearing.

   (iii) Under subsection 1125(f)(1), the court may also determine that the plan itself contains adequate information so that a separate disclosure statement is not required.

f) Procedural requirements for conditional approval of disclosure statements - Rule 3017.1 (see above).

[6] *See* A. Thomas Small, *Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. (1993).

[7] Jacob Barron, NACM Survey: *"Fast-Track" Bankruptcy Proceedings Uncommon*, 110 v. 8 Business Credit 53, 53 (2008).