Looking Under the Hood of the Commission's Recommendations on SMEs: Simple, Speedy and Effective

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On December 8, 2014, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 ("Commission") released its Final Report and Recommendations ("Report"). Part VII of the Report contains the Commission's recommendations for small or medium-sized enterprise cases (SMEs). In this Article, the first of several comparing the Commission's recommendations for SMEs with the Bankruptcy Code's small business provisions, I contrast the Commission's fairly straightforward definition of an SME with the Code's more complicated small business debtor definition.

The Commission's Definition
The Commission defines an SME as follows:

> 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.[1]

In order to demonstrate how the Commission's definition would work, take the hypothetical chapter 11 filing of Poe, Inc. Poe is a family-run business in financial distress. It is not engaged in real property activities. Marie and Roger, a married couple, each own 50% of Poe's shares, which are not publicly traded. Marie and Roger also serve as the firm's President and Vice-President, respectively. Poe has $800,000 in assets and total liabilities of $1.75 million. A small amount of Poe's debt ($75,000) includes liabilities owed to Marie and Roger for loans that they made to the firm. Because the couple's financial fortunes are tied up with those of the business, Marie and Roger also are experiencing financial difficulties. Marie and Roger have assets of $525,000; they have both consumer and business debts of $1 million, $200,000 of which are guarantees of Poe's debt.[2]

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[1] AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11, 2012-2014 FINAL REPORT AND RECOMMENDATIONS 279 (2014) (emphasis in original) [hereinafter Commission Report].

[2] This example places Poe squarely in the middle of the range of business debtors who filed for relief under chapter 11 in 2007. Approximately half the 2007 business debtors had $1 million or less in assets and about 58% had $2.19 million or less in liabilities at the start of their chapter 11 cases. In 2007, the Code's small business debtor definition had a liability ceiling of $2.19 million. *See* Commission Report, *supra* note 1, at 287.

Poe files for relief under chapter 11. A week later, Marie and Roger, filing jointly, join Poe in chapter 11.

Making It Simpler

For several reasons, the Commission's definition of an SME is easier to apply than the Bankruptcy Code's small business debtor definition. The flowchart in Figure 1 provides the questions a prospective debtor must answer to determine whether it qualifies as an SME.

First, Marie and Roger's joint chapter 11 case does not qualify as a case to which the Commission's SME principles apply. Unlike the Bankruptcy Code's small business debtor definition, the Commission's SME definition does not include individual chapter 11 filers. The Code's small business debtor definition applies to a "person engaged in commercial or business activities;" the term "person" includes individuals.[3] Depending on whether the couple's debts are primarily consumer or business in nature, Marie and Roger's case might qualify as that of a small business.[4] The Commission's definition, on the other hand, applies to a "business debtor," a term that the Commission makes clear in its commentary does not include individual chapter 11 debtors. "[T]he 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."[5] Thus, the Commission's definition eliminates the need to resolve questions about the filing status of individual debtors who have both business and personal liabilities at the time of bankruptcy filing.

Second, single asset real estate ("SARE") cases do not qualify as SMEs. Poe is not in the real estate business; hence, the SARE exclusion does not exempt it from SME status. For debtors involved in real property activities, however, the Commission's definition makes it easy for them to determine whether they qualify for this exclusion from SME status. The Code defines a SARE.[6] If a debtor qualifies as a SARE, then that debtor is not an SME.

By comparison, the real property exclusion in the Code's small business debtor definition covers more than SAREs. It also excludes from small business treatment any debtor whose "primary activity is the business of owning or operating real

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[3] 11 U.S.C. §101(51D)(A) (2012) (small business debtor definition); 11 U.S.C. §101(41) (2012) (definition of person).

[4] *See* Official Form B1, Voluntary Petition (front page of petition contains check box describing "Nature of Debts" as primarily consumer or primarily business).

[5] Commission Report, *supra* note 1, at 288. The Commission determined that reform proposals for individual debtors were beyond its charge. *See id.* at 317. The ABI Anthony H.N. Schnelling Endowment has funded an empirical study of individual chapter 11 debtors. Professor Margaret Howard of Washington and Lee School of Law is the study's reporter, and Professor Rich Hynes of the University of Virginia School of Law is the principal investigator.

[6] *See* 11 U.S.C. §101(51B) (2012).

property or activities incidental thereto."[7] Congress did not define this phrase, thereby raising questions about the exact contours of the exclusion.[8]

Third, the Commission's definition excludes from SME status any debtor with "publicly traded securities in its capital structure or in the capital structure of any affiliated debtors."[9] Poe Corporation's shares are privately held; therefore, Poe may still qualify as an SME. Marie and Roger, the firm's affiliated debtors,[10] are individuals, not artificial entities, and, hence, the phrase "publicly traded shares in the capital structure" simply does not apply to them. The "publicly traded securities" exclusion is easy to use. It only applies if the debtor (1) is an artificial entity with publicly traded securities *or* (2) is part of a jointly administered case in which any of the affiliated debtors has publicly traded securities in their capital structure.

The final step in determining SME status requires an examination of the assets and liabilities of the debtor and all its affiliates, both debtor and non-debtor. In our hypothetical, Marie and Roger are Poe-affiliated debtors. As a result, determination of Poe's status as an SME requires an examination not only of Poe's total assets and liabilities, but also Marie and Roger's total assets and liabilities. This is a simple process, however. Poe has assets of $800,000; adding Marie and Roger's individual assets results in total assets of $1.325 million. Because the Commission's definition is framed in the alternative – less than $10 million in assets *or* liabilities - Poe is an SME.

The analysis of whether Poe is a small business debtor is far more complicated. To begin, the Code requires that Poe's counsel subtract contingent and unliquidated debts from the liability totals for both Poe, and Marie and Roger in order to determine small business status. Poe has liabilities of $1.75 million, none of which are contingent or unliquidated. Marie and Roger owe $1 million, but $200,000 of that amount is contingent – guarantees of corporate debt. Thus, as a group, the debtors have $2.55 million in non-contingent liquidated liabilities, which exceeds the Code's current statutory ceiling of $2,490,925 for small business debtors.

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[7] 11 U.S.C. §101(51D)(A) (2012).

[8] Anne Lawton, *An Argument for Simplifying the Code's "Small Business Debtor" Definition*, 21 AM. BANKR. INST. L. REV. 55, 72-76 (2103) [hereinafter *Simple Definition*] (discussing the Code's exclusion from small business status for debtors whose primary activity is owning or operating real property); Anne Lawton, *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success*, 54 ARIZ. L. REV. 985, 1026 n. 149 (2012) [hereinafter *Chapter 11 Triage*] (comparing the required disclosure for SAREs on the schedules and statements with the absence of such disclosure for debtors whose primary activity is owning or operating real property).

[9] Commission Report, *supra* note 1, at 279.

[10] The Bankruptcy Code defines an affiliate, in part, as an "entity that directly or indirectly owns, controls or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor." 11 U.S.C. §101(2)(A) (2012). Marie and Roger each hold 50% of the outstanding shares of Poe and, thus, are affiliates of the corporation.

The Code, however, also excludes from the category of relevant liabilities any debts owed to affiliates or insiders. Marie and Roger are both affiliates and insiders of Poe Corporation.[11] As a result, the $75,000 that Poe owes them for the loans that they made to the corporation is affiliate and insider debt. Subtracting that amount from $2.55 million means that Poe now qualifies as a small business debtor, with liabilities just below the Code's current liability ceiling.

Not only is the Code's process for identifying small business debtors far more complicated than the Commission's for determining SME status, it also is extraordinarily difficult to use given the current version of Official Form B6. The Summary of Schedules provides the amount of the debtor's total liabilities, as well as a breakdown of that liability figure by secured, priority unsecured, and general unsecured debt. Nowhere on Form B6 must the debtor provide totals of its non-contingent, unliquidated, affiliate, and/or insider debt.[12] Thus, for contingent and unliquidated liabilities, the U.S. Trustee, Bankruptcy Administrator, or creditor interested in challenging the debtor's small business designation must look at each page of the debtor's schedules to find those liabilities for which the debtor checked the "contingent" or "unliquidated" columns next to the description of the debt. In order to properly account for affiliate and insider debt, the U.S. Trustee, Bankruptcy Administrator, or a creditor must engage in a two-step process: (1) determine which individuals or entities qualify as insiders and/or affiliates of the firm; and then (2) look at each page of the debtor's schedules to locate affiliate and insider liabilities.

This process is largely a waste of time. For example, in an earlier study of 782 randomly selected chapter 11 cases filed in 2004, I found that including contingent and unliquidated liabilities when calculating liability totals increased by only 30 the number of cases that exceeded the $2 million liability ceiling then in effect.[13] Thus, deducting contingent and unliquidated debt affected the small business determination in less than 4% of the cases in the random sample.

The Commission's changes to the calculation of liabilities coupled with its decision to trigger SME status based on either a debtor's aggregate liabilities *or* assets makes it easier for both creditors and the U.S. Trustee or Bankruptcy Administrator to identify debtors who qualify as SMEs. Rather than scrolling through pages of schedules to subtract from liability totals contingent and unliquidated debts as well

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[11] For a corporation, an insider includes the firm's officers and directors. See 11 U.S.C. §101(31)(B)(i), (ii) (2012).

[12] The Committee on Rules of Practice and Procedure of the Judicial Conference of the United States has proposed changes to various Official Forms, including the Summary of Schedules. *See* Proposed Official Form 206Sum *available at* http://www.regulations.gov/#!documentDetail;D=USC-RULES-BK-2014-0001-0001. The proposed Official Form 206Sum, however, does not include separate reporting of contingent, unliquidated, affiliate or insider debt.

[13] *See Chapter 11 Triage, supra* note 8, at 1012, 1014 (flowcharts showing 558 debtors of 782 qualified as small business debtors if contingent and unliquidated debts were subtracted from liability totals, while 528 debtors of 782 so qualified based on liability totals on the Summary of Schedules).

as liabilities owed to affiliates and insiders, creditors and the U.S. Trustee or Bankruptcy Administrator need look only at the total assets and total liabilities boxes on Official Form B6.

Admittedly, the Commission's SME definition is less precise than the Code's small business debtor definition with regard to the calculation of aggregate liabilities.[14] But does it matter? The answer is "no," because the Commission not only raised the liability limit to $10 million, it also provided that debtors may qualify for SME status if consolidated assets fall below the $10 million line. The Commission based its $10 million asset or liability ceiling for SME status on data from approximately 640 businesses that filed for relief under chapter 11 in 2007.[15] More than half of those debtors had assets or liabilities below $2.19 million, while 84% had assets and 78% had liabilities under $5 million.[16] Thus, most debtors have assets or liabilities far below the Commission's SME ceiling already; deducting contingent, unliquidated, affiliate, or insider debt likely will make no difference to their status as SMEs, even with affiliate assets and liabilities added to the mix.

Moreover, the Commission created a "soft" ceiling. Debtors with consolidated assets and liabilities of $10 million or more but consolidated assets or liabilities of less than $50 million may request treatment as an SME. The bankruptcy court then must decide on an expedited basis whether "treating the debtor as an SME in the chapter 11 case is in the best interest of the estate."[17] Thus, the Commission's decision to simplify the calculation of liabilities by deleting the Code's requirement to deduct contingent, unliquidated, affiliate and insider debt likely will affect the SME status of an incredibly small number of chapter 11 debtors.

Making It Faster

The other advantage of the Commission's SME definition is that early in the chapter 11 case the focus shifts from debates about the debtor's status to the work necessary to rehabilitate the debtor's business. The Commission accomplishes this goal in two ways.

First, the Commission recommends that a "committee of unsecured creditors under section 1102(a) should not be appointed in an SME case" unless a creditor or the U.S. Trustee files a timely motion seeking appointment.[18] In addition, appointment of an official committee of unsecured creditors makes no difference to an entity's

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[14] Because the SME definition does not require deduction of contingent debt, double counting of some liabilities may occur. For example, counting the $200,000 debt owed by Poe twice – once on Poe's schedules and a second time on Marie and Roger's as a contingent liability – exaggerates aggregate liabilities.

[15] *See* Commission Report, *supra* note 1, at 287.

[16] *See id.* In 2007, $2.19 million was the Code's liability ceiling for small business status.

[17] *Id.* at 279.

[18] *Id.* at 291. The Commission does not include the Bankruptcy Administrator in its SME recommendations.

status as an SME. By comparison, the Code excludes from small business treatment any case in which the U.S. Trustee appoints an official committee of unsecured creditors. The problem is that formation of an official committee of unsecured creditors takes time, which, in turn, delays a final determination as to which debtors qualify as small business debtors.[19] But, if formation of an official committee of unsecured creditors has no effect on SME status, then in the vast majority of cases in which debtors have no publicly traded securities, there is no delay between the debtor's designation as an SME on the petition and its treatment as an SME.

That brings me to the second reason why the Commission's process for identifying SMEs is faster than that of the Code for identifying small business debtors. The Commission recommends significantly shortening the time period for objection to the debtor's designation as an SME. Objections should "be filed on or before 14 days after the notice of the debtor's indication in the petition that it qualifies as an SME."[20] Under the Code, the U.S. Trustee or a party in interest has 30 days from the later of the conclusion of the §341 meeting or any amendment to the debtor's designation on the petition to file an objection to the debtor's status as a small or non-small business.[21]

In other words, the Commission's goal is not to devote money, time, and resources to arguing about whether an entity qualifies as an SME, but rather to ensure that smaller enterprises that qualify as SMEs obtain the help that they need in order to successfully reorganize. As the Commissioners note in their Report, many SMEs fail "not because of fatally flawed business models, but because they [are] not receiving the assistance they need[ ] in the context of a financial restructuring."[22] The earlier in the process that the debtor's status as an SME is finalized, the earlier the parties can turn their attention to the debtor's financial rehabilitation.

Conclusion

In its Report, the Commission explains that in drafting the SME recommendations it sought to accomplish three primary objectives: "(i) simplify[ ] the process; (ii) reduc[e] costs and barriers; and (iii) provid[e] tools to facilitate effective reorganization for viable companies."[23] The Commission's SME definition certainly achieves the first two objectives. The definition is easy to apply, thereby making the process of SME designation on the petition relatively straightforward for the vast majority of chapter 11 debtors. For creditors, determining whether a debtor's consolidated assets or liabilities fall below the $10 million ceiling set for automatic SME status involves little more than a quick look at the totals on the Summary of Schedules, rather than a labor-intensive search through pages of schedules to

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[19] *See* Fed. R. Bankr. P. 1020(c) (stating that a case proceeds as a small business case once a committee of unsecured creditors is appointed pursuant to §1102(a)).

[20] Commission Report, *supra* note 1, at 279.

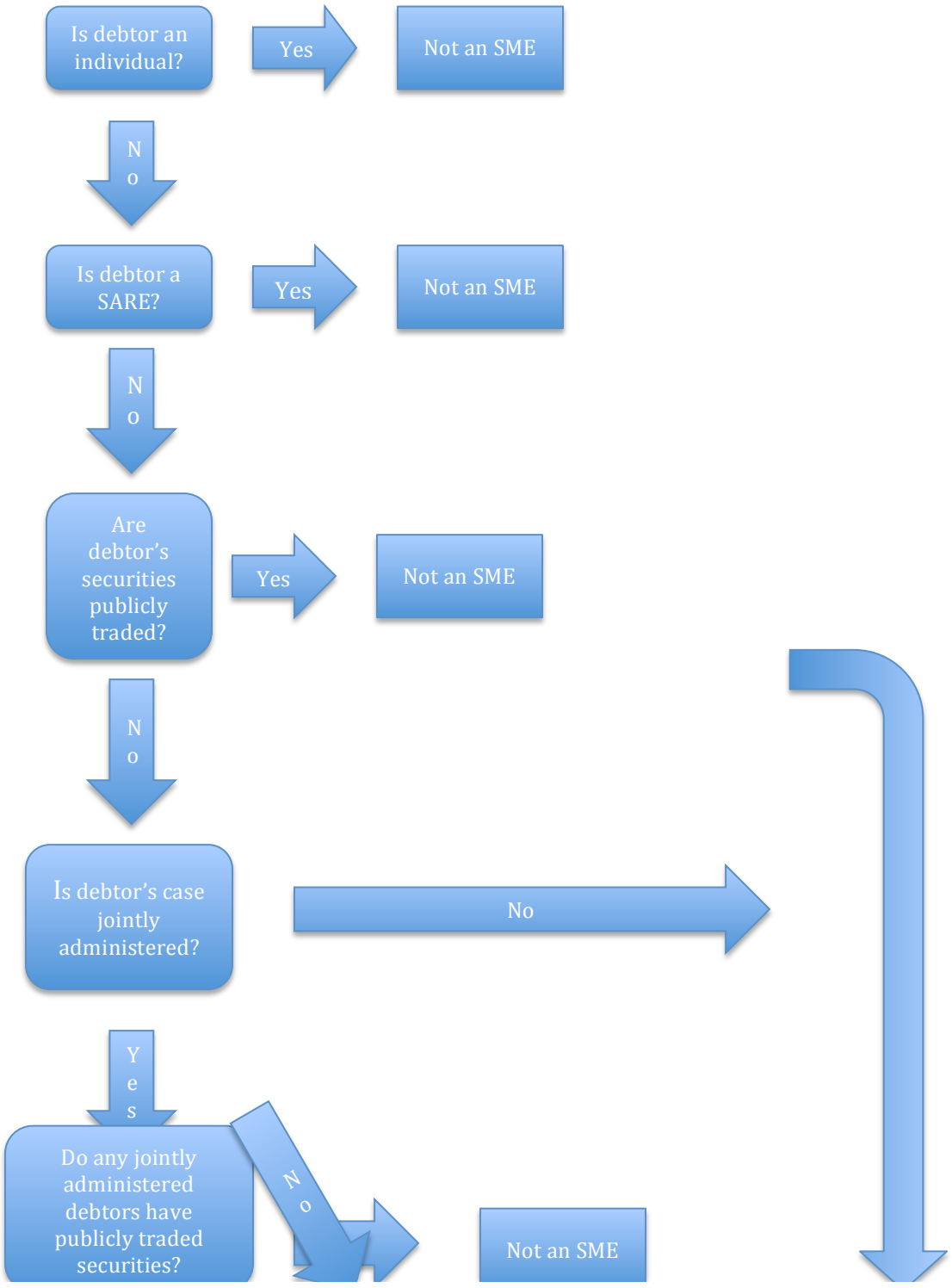
[21] *See* Fed. R. Bankr. P. 1020(b).

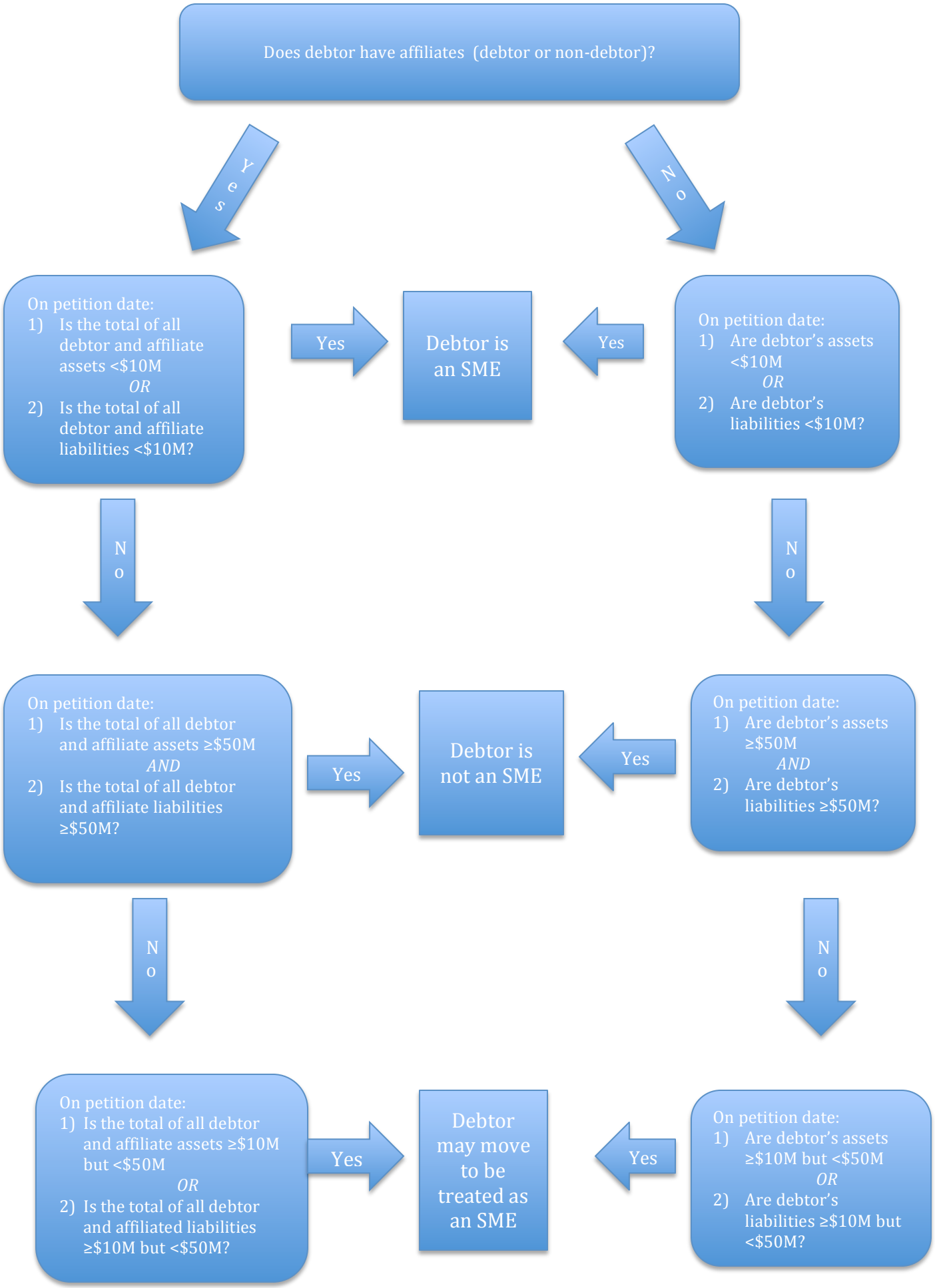
[22] *See* Commission Report, *supra* note 1, at 285.

[23] *Id*. at 290.

identify contingent, unliquidated, affiliate and insider debt. At the same time, the process is faster, requiring objections to a debtor's designation as an SME to be filed within 14 days of the petition, rather than the later of 30 days from the conclusion of the §341 meeting or any amendment to the debtor's designation on the petition. All these changes reduce cost. A simpler, faster process means that debtors and parties in interest spend less time arguing about the debtor's status and more time devoted to the debtor's efforts to reorganize in chapter 11.

Figure 1. Is a Business Debtor a Small or Medium-Sized Enterprise ("SME")?




Does debtor have affiliates (debtor or non-debtor)?
Yes
No
On petition date:
1) Is the total of all debtor and affiliate assets <$10M
OR
2) Is the total of all debtor and affiliate liabilities <$10M?
Yes
Debtor is an SME
Yes
On petition date:
1) Are debtor's assets <$10M
OR
2) Are debtor's liabilities <$10M?
No
No
On petition date:
1) Is the total of all debtor and affiliate assets ≥$50M
AND
2) Is the total of all debtor and affiliate liabilities ≥$50M?
Yes
Debtor is not an SME
Yes
On petition date:
1) Are debtor's assets ≥$50M
AND
2) Are debtor's liabilities ≥$50M?
No
No
On petition date:
1) Is the total of all debtor and affiliate assets ≥$10M but <$50M
OR
2) Is the total of all debtor and affiliated liabilities ≥$10M but <$50M?
Yes
Debtor may move to be treated as an SME
Yes
On petition date:
1) Are debtor's assets ≥$10M but <$50M
OR
2) Are debtor's liabilities ≥$10M but <$50M?