

Office of Advocacy

TESTIMONY

of

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before the

**SUBCOMMITTEE ON ADMINISTRATIVE
OVERSIGHT AND THE COURTS**

**COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE**

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on

The Business Bankruptcy Reform Act of 1998, S. 1914

SUMMARY

Entrepreneurism is the foundation of this nation's economy and small businesses. As debtors and creditors, entrepreneurs need a bankruptcy system that is fair, equitable and flexible enough to accommodate the individual needs of different industries, the complexities of varying businesses and the regional economies around the country.

Of the 1.4 million bankruptcy filings in 1997, only 9,694 of the Chapter 11 filings (0.69 percent) and 11,095 filings of the Chapter 13 filings (0.79 percent) were business-related. Overall, small business bankruptcies declined 33.9 percent from 1987 to 1997. During that same time period new business formations increased by 18.2 percent. At this time, small business bankruptcies appear to be less a problem for the bankruptcy system than 10 years ago.

I have three primary concerns with S. 1914. First, S. 1914 will make the bankruptcy system too rigid for small business debtors. Second, this legislation imposes disproportionate burdens on small business debtors compared with the burdens imposed on large business. And third and most important, I believe that, if adopted, this legislation in its current form would have a chilling effect on

entrepreneurism in our country. S. 1914's new duties, new reports, shortened time frames, and higher thresholds for obtaining extensions represent less flexibility and much higher hurdles for small businesses than the current Chapter 11 provisions.

I believe that sufficient research and dialogue has not occurred on small business bankruptcy issues or on the small business recommendations of the National Bankruptcy Review Commission. It is clear from the statistics that small business reorganizations have not imposed a critical burden on the bankruptcy system. In light of the significant changes that will arise if S. 1914 is adopted, I strongly recommend that you defer consideration of any amendments to the U.S. Bankruptcy Code with respect to the definition of small business, the mandatory use of the definition, the shortened time considerations, new duties for small business debtors, and higher legal thresholds for any extensions affecting small businesses until we are able to fully assess the impact of the proposed changes on the small business community and our nation's economy. Any amendments to the U.S. Bankruptcy Code without full comprehension of the consequences could irreparably damage the entrepreneurial spirit that has made our economy as strong as it is today.

Good afternoon, Chairman Grassley and members of the Committee, I am Jere Glover, Chief Counsel for Advocacy of the U.S. Small Business Administration. I am pleased to appear before your subcommittee to discuss the small business provisions of the Business Bankruptcy Reform Act of 1998, S. 1914.

The Office of Advocacy of the U.S. Small Business Administration was created by Congress to be the independent voice for small businesses within the Federal government and to represent the views of small business before Congress and Federal regulatory agencies.[\(1\)](#)

Entrepreneurism is the foundation of this nation's economy and small businesses. As debtors and creditors, entrepreneurs need a bankruptcy system that is fair, equitable and flexible enough to accommodate the individual needs of different industries, the complexities of varying businesses and the regional economies around the country.

I believe that the proposed Business Bankruptcy Reform Act of 1998, S. 1914, would make fundamental, expansive and potentially detrimental changes to entrepreneurship by altering bankruptcy protections for small businesses seeking to reorganize under Chapter 11 of the U.S. Bankruptcy Code. Chapter 11 and its amendments were designed to permit businesses having trouble paying their debts and liabilities to reorganize and restructure in order to return to profitability. To accommodate the different types of businesses, the varying types of bankruptcies

and the various remedies to return a company to profitability, Chapter 11 was designed to be flexible.

The last time the Congress considered changes to the U.S. Bankruptcy Code, it acknowledged that businesses are not all alike. The 1994 amendments to the U.S. Bankruptcy Code recognized that a "one-size-fits-all" [\(2\)](#) Chapter 11 is not in the best interests of small business and I believe the proposed mandatory "one-size-fits-all" definition for small business and the proposed stringent procedural requirements come dangerously close to undermining the intent of the 1994 amendments. In 1994, I commented on this exact issue. Attached please find a copy of my letter to Jack Brooks, Chairman, House Committee on the Judiciary, dated September 7, 1994. The 1994 amendments maintained flexibility.

Chapter 11 provides an orderly and equitable way for debtors to reorganize their businesses with their creditors. Several bankruptcy courts around the country have implemented other successful small business bankruptcy reorganization systems without any changes to the U.S. Bankruptcy Code. This is further evidence that "flexibility" in Chapter 11 is not only workable but apparently desirable. Since the courts have on their own initiative addressed the issue with innovations, I strongly recommend that Congress defer consideration of any amendments that fundamentally change the bankruptcy laws for small business debtors and creditors until the implications of the proposals have been more fully researched and discussed.

Overview of the Importance of Small Business in the United States Economy

The United States has a strong and vital economy envied by the world. We encourage entrepreneurship and the creation of businesses in order to drive our free market system. Currently, there are 23.3 million small businesses in the United States, the vast majority of which are very small, but all of which have aspirations to grow. Our small business community continues to maintain and sustain our economy.

A number of small business trends are affecting our economy:

- Small firms created virtually all of the net new jobs between 1992 and 1996 (see attached chart). While the Fortune 500's share of U.S. employment has declined steadily since 1968, small business entrepreneurs have filled the gap (see attached chart).
- It is estimated that the fastest growing segment of the small business community, called "gazelles" by many analysts, numbers 300,000 businesses.
- Our country is experiencing a major "information revolution" similar to the earlier industrial revolution-propelled, at least initially, by small businesses. Our service-based industries are booming, with the

information and technology sectors growing at an accelerated rate (see attached chart).

- o Small businesses are taking advantage of the global marketplace. A recent study completed for the Office of Advocacy shows that small businesses are exporting at a much greater rate than ever before.(3)

Every year, our economy experiences dynamic changes through the births and terminations of businesses. Last year a record 884,609 firms with employees were created. In contrast, only 54,027 business-related bankruptcies-primarily liquidations under Chapter 7-were filed.(4) A high rate of business formation and dissolution is characteristic of a dynamic economy. Our nation's economy is characterized by this dynamic and by the special role played by small business entrepreneurs to sustain overall growth.

Experience and our research have shown that many entrepreneurs do indeed fail at their first attempts at business, but it is through their experience of failure that they find the right formula for success.(5) Unlike some European countries where business failure is a stigma for those who do not succeed on the first try, the United States has built its free market on competitive principles and entrepreneurs' ability to try again. Failure should not be a hindrance to future success.

Of the 1.4 million bankruptcy filings in 1997, only 9,694 of the Chapter 11 filings (0.69 percent) and 11,095 filings of the Chapter 13 filings (0.79 percent) were business-related.(6) Overall, small business bankruptcies declined 33.9 percent from 1987 to 1997. During that same time period new business formations increased by 18.2 percent. At this time, small business bankruptcies appear to be less a problem for the bankruptcy system than 10 years ago.

The entrepreneurial spirit is fueling our nation's economy and permits entrepreneurs to take a challenge and face risks in order to succeed. The U.S. Bankruptcy Code, while not perfect, has allowed small businesses the flexibility to reorganize and has permitted local bankruptcy courts to adopt policies that support local industries and diverse economies. This flexibility needs to be maintained in order for the entrepreneurial spirit to continue and grow.

The Office of Advocacy's Concerns with S. 1914

As with any piece of major legislation, a delicate balance must be maintained in any amendments to ensure that affected entities receive fair and equitable treatment. S. 1914 proposes substantial changes in the way small businesses reorganize under Chapter 11, which may undermine this treatment for small business debtors. The bill proposes to establish strict timelines for filings and submissions of plans, mandatory filing of monthly financial reports, and mandatory standardized disclosure forms for those reports by small firms. In addition, the bill would create higher thresholds for extensions of deadlines and

would establish new duties for the U.S. Trustees. Other provisions of the bill would expand the grounds for conversion and dismissal of business bankruptcies.

I have three primary concerns with S. 1914. First, S. 1914 will make the bankruptcy system too rigid for small business debtors. Second, this legislation imposes disproportionate burdens on small business debtors compared with the burdens imposed on large business. And third and most important, I believe that, if adopted, this legislation in its current form would have a chilling effect on entrepreneurship in our country.

S. 1914's new duties, new reports, shortened time frames, and higher thresholds for obtaining extensions represent less flexibility and much higher hurdles for small businesses than the current Chapter 11 provisions.

The legislation attempts to move very small businesses through the bankruptcy system quickly without taking into account that for many this may be the first time in bankruptcy. Unlike their large business counterparts, small businesses cannot afford top turnaround teams or management consultants. They may need additional time and guidance to become organized and educated about bankruptcy procedures.⁽⁷⁾ Under these proposed amendments, small business entrepreneurs must attempt to comply with all of these additional duties and filing requirements in a shorter time frame while continuing to run their business. The slightest infraction or delay will require the small business debtor to spend more time in court and could even result in dismissal or conversion under the expanded criteria.

In addition, two factors are changing our economy that will require greater flexibility for small business debtors in bankruptcy: our economy is moving from a manufacturing to a service and information base, and small businesses are taking advantage of a global marketplace. Small service business debtors may not have the real estate or manufacturing equipment, assets typical of other industries' reorganizations. Small business exporters may encounter international situations that present problems outside of the debtors' control. These businesses may require unique reorganization concepts in order to return to profitability. Under S. 1914, the time and flexibility needed to address special circumstances will be severely restricted.

Small business bankruptcies under Chapter 11 do not appear to present an increasing problem to the bankruptcy system at this time. In fact, business bankruptcies have declined over the past decade and are moving through the system in one-third less time. Chapter 11 cases represented fewer than 1 percent of bankruptcy filings last year. Several bankruptcy courts around the country have adopted small business procedures that take into account the type of business bankruptcy and regional economic factors. These initiatives should be encouraged. They retain the flexibility of Chapter 11 and the essential elements of judicial discretion and oversight of the cases while allowing for local answers to local situations.

There are some provisions of S. 1914 that I believe could be adopted but with qualification. To further increase the efficiency and effectiveness of these initiatives, I believe that the provisions of S. 1914 to establish standardized financial and confirmation plan forms should be adopted. These forms, however, should be drafted so that they do not discriminate against service-based industries. I therefore recommend that S. 1914 be amended to require consultation with the U.S. Small Business Administration in the drafting of these standardized documents.

While standardized forms may facilitate the process, I nevertheless believe that this legislation will impose disproportionate burdens on small business debtors compared with large business debtors. As stated before, these include new duties, financial documents and filings on small business debtors. None of these proposals would apply to large business debtors.

A prime example is the higher legal threshold for small business debtors to gain an extension of time to file documents. Currently, under section 1121(d) of Title 11 of the United States Code a business debtor may obtain an extension by showing "cause." S. 1914 would require all small business filers, and only small business filers, to prove by "clear and convincing" evidence that each bankruptcy will confirm a plan of reorganization within a reasonable period of time. This standard is even higher than the "preponderance of the evidence" standard proposed in the Bankruptcy Reform Act of 1998, H.R. 3150. In both proposals, small business debtors have to abide by a higher standard while large businesses will have only to prove "cause" to gain an extension. This is intrinsically unfair.

The most significant proposed change contained in S. 1914 is that the voluntary election of the small business provisions permitted under Chapter 11 would be made mandatory for all businesses with aggregate liabilities of up to \$5 million. According to the National Bankruptcy Review Commission's statistics, 85 percent of commercial bankruptcies under Chapter 11 would be forced to use the small business provisions. With the amendments in 1994, the small business provisions were created with full knowledge that all small businesses are not alike.⁽⁸⁾ Some businesses seeking reorganization may have less complicated reorganization plans and may opt to use the expedited provisions.

Unfortunately, S. 1914 would adopt a "one-size-fits-all" definition for small businesses regardless of the complexity of the bankruptcy, the industry of the small business, and/or any regional economic factors. In my experience with Federal regulatory agencies, blanket "one-size-fits-all" regulations typically do not target the specific problems that need to be addressed and usually have unforeseen consequences on small entities. In order to reduce the disproportional regulatory burden on small entities, Congress mandates that Federal agencies prepare regulatory flexibility analyses on the potential regulatory and economic impacts on small entities.⁽⁹⁾ I believe that the same principle should be applied here in order to quantify and identify the precise problems of small business

bankruptcy reorganizations and the appropriate measures to make Chapter 11 work more efficiently and effectively.

Finally, I believe that this legislation could have a chilling effect on entrepreneurship in the United States. Our free-market economy encourages entrepreneurs to take challenges and face risks in order to succeed. The evidence of our strong economy is evidence of our entrepreneurial base. As stated before, virtually all net new jobs created between 1992 and 1996 were created by small businesses.

I believe that the changes proposed in S. 1914 are of such immense proportion that further discussion is needed to address the full impact of the proposals on entrepreneurship, the small business community and our national economy. As the Bankruptcy Review Commission acknowledged in its Small Business Proposals, existing data on bankruptcies is poor. While research has been undertaken to show how quickly business bankruptcies go through the system and how they exit the system, no in-depth research has been done to understand how the bankruptcy system aids or impedes small business debtors and creditors.⁽¹⁰⁾ Even independent research done for the Office of Advocacy on small business bankruptcies has been significantly hampered by the lack of statistical data maintained by the courts.⁽¹¹⁾ Before Congress fundamentally alters the way small businesses operate as debtors and as creditors, it should analyze whether the proposed changes will undermine the entrepreneurial spirit in this country.

Moreover, I believe that S. 1914, if adopted, will irreversibly change the relationship between creditors and debtors. S. 1914 has been presented as beneficial for small business creditors. Unfortunately, I do not agree. In our experience, we have found that small businesses are most likely to be creditors in an unsecured position. If small businesses are discouraged from using the bankruptcy system and just close their doors, then their unsecured creditors may actually be in a worse position than under the current Chapter 11 system.

Further, one unintended result of the proposed mandatory provisions of S. 1914 is that we may discourage small businesses from utilizing the bankruptcy system. By discouraging small businesses from using the bankruptcy system, we rob small business creditors of the equitable and orderly resolution of debts the bankruptcy system was designed to facilitate.

Conclusion

I believe that sufficient research and dialogue has not occurred on small business bankruptcy issues or on the small business recommendations of the National Bankruptcy Review Commission. It is clear from the statistics that small business reorganizations have not imposed a critical burden on the bankruptcy system. As stated earlier, only 0.69 percent of all bankruptcy filings in 1997 were business-related reorganizations under Chapter 11. In addition, business-related

bankruptcies declined by 33.9 percent between 1987 and 1997. According to the U.S. Trustees, the time businesses spend in Chapter 11 has declined significantly since 1992.

From a small business perspective, the system appears to be working in its intended manner. Before fundamental and irreversible changes to the bankruptcy system are made we need to quantify the problem. The opportunity is ripe for developing better statistical data and more comprehensive research on how the bankruptcy system for reorganizations has been beneficial and/or detrimental to small business debtors and creditors. S. 1914 has several provisions that address the need for more statistical data on bankruptcies.

In light of the significant changes that will arise if S. 1914 is adopted, I strongly recommend that you defer consideration of any amendments to the U.S. Bankruptcy Code with respect to the definition of small business, the mandatory use of the definition, the shortened time considerations, new duties for small business debtors, and higher legal thresholds for any extensions affecting small businesses until we are able to fully assess the impact of the proposed changes on the small business community, federal loan and investment programs, and our nation's economy. Any amendments to the U.S. Bankruptcy Code without full comprehension of the consequences could irreparably damage the entrepreneurial spirit that has made our economy as strong as it is today.

In sum, I recommend the following with respect to S. 1914:

- Maintain the current definition of small business;
- Adopt standardized financial disclosure and confirmation forms with input from SBA to ensure that the documents do not discriminate against service-based industries;
- Encourage voluntary education and debtor classes for the smallest of Chapter 11 debtors;
- Put aside the provisions requiring mandatory use of the small business provisions;
- Do not codify additional duties of small business debtors;
- Keep current time frames; and
- Keep current legal thresholds for small businesses and do not adopt two separate legal standards (one for small businesses and one for large businesses) for requests for extension of time.

Thank you for the opportunity to appear today. I am happy to answer any questions that you may have about my testimony.

ENDNOTES

1. The Office of Advocacy, established by Public Law 94-305, is an independent office charged with representing the views and interests of small businesses before the Federal government. By law, the Chief Counsel is appointed by the President from the private sector and confirmed by the

Senate. The Chief Counsel's comments and views are his own and do not necessarily reflect the views of the Administration or the U.S. Small Business Administration.

2. Public Law 103-394, Title II, Section 217.

3. "Exporting by Small Firms," Office of Advocacy, U.S. Small Business Administration, April 1998.

4. Administrative Office of the U.S. Courts.

5. See Richard F. Fullenbaum and Marianna A. McNeill, *The Function of Failure*, prepared by M & R Associates, for the U.S. Small Business Administration, Office of Advocacy (Springfield, Va.: National Technical Information Service, 1994). See attached copy of the research summary.

6. Administrative Office of the U.S. Courts.

7. The U.S. Trustees in Dallas and San Francisco have established voluntary debtors' schools to educate and help debtors file their financial statements.

8. Letter to Jack Brooks, Chairman, House Committee on the Judiciary, dated September 7, 1994.

9. The Regulatory Flexibility Act, Public Law 96-354. The Office of Advocacy of the U.S. Small Business Administration is charged with monitoring Federal regulatory agencies' compliance with the Regulatory Flexibility Act.

10. Specifically, research should include but not be limited to the following questions: what are the causes of bankruptcy (i.e., economic conditions, loss of production facilities, loss of federal government contracts, international affairs, etc.), what are the specific size classifications of small businesses that use Chapter 11 effectively, are there specific industries that have problems reorganizing under Chapter 11 (i.e., do service sector businesses or businesses relying on intellectual property rights need more time to file reorganization plans), what is the success rate of businesses five and ten years after completing a reorganization, and are there specific small business remedies that do not require wholesale changes for all business reorganizations.

11. Fullenbaum and McNeill, *The Function of Failure*.

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