Statement of Douglas G. Baird*

on behalf of the

NATIONAL BANKRUPTCY CONFERENCE

at the Hearing on

Bankruptcy Law: Overview and Legislative Reforms

Before the

Subcommittee on Antitrust, Commercial and Administrative Law

of the Committee on the Judiciary

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I am grateful to be able to speak to you today on behalf of The National Bankruptcy Conference. The Conference was established in the 1930s, and it is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors, and judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and proposed changes to those laws.

In my comments today, I wish to emphasize principally the need to increase the existing cap for small businesses seeking to reorganize under subchapter V. The empirical evidence suggests that Sub V has led to quicker reorganizations, at lower cost, and with a higher rate of success than possible under a traditional Chapter 11. See American Bankruptcy Institute, Final Report of the American Bankruptcy Institute Subchapter V Task Force (2024). Some, however, have speculated that distressed debtors might enjoy the benefit of Sub V at the expense of creditors. If creditors do worse under Sub V, in theory at least, creditors might be forced to raise interest rates, and this might in turn harm potential entrepreneurs. The empirical evidence to date, however, does not suggest that this is happening.

Sub V has been an unequivocal success in providing a more streamlined and less costly means of resolving financial distress and has fulfilled the principal goals of the legislation. Fully 52% of subchapter V debtors successfully confirm plans. This stands in contrast to the 31% of comparable debtors who used chapter 11 before subchapter V was put in place. And the reorganizations are faster. Time to confirmation for small businesses is lower as well. Moreover, bankruptcy judges dismiss cases that are not going to succeed more quickly.

Under subchapter V, creditors continue to have the protections available in a traditional chapter 11 case, including the ability to seek dismissal or conversion of the case, removal of the debtor in possession, and relief from the automatic stay. Secured creditors enjoy the same protection for the value of their collateral in subchapter V that they enjoy in large chapter 11s. The plan must satisfy the same provisions of §1129(b)(2)(A) of the Bankruptcy Code, and creditors have a right to contest confirmation of any plan they oppose. A nonconsensual plan can be confirmed only if the plan gives secured creditors at least the value of their collateral.

Nor is there a qualitative difference in the way subchapter V treats unsecured creditors. The only significant change lies in a modification of the long-standing right of old equity to participate in return for providing new value. In traditional reorganizations, old equityholders must contribute new value "in money or money's worth" to receive any recovery under a plan if a class of unsecured creditors rejects the plan. *Case v. Los Angeles Lumber Products*, 308 U.S. 106 (1939). Subchapter V similarly requires principals to provide new value, but it permits that value to take on a different form. Instead of cash, old equity holders can contribute sweat equity. In return for giving up income that they generate by running the business *in the future*, they are allowed to retain their ownership and their jobs in the company.

For unsecured creditors, from a purely business perspective, the prospect of a monthly check in payment of their claims is usually a better bargain than foreclosure and the risks associated with it (such as responsibility for taxes and insurance) that come with a transfer of ownership to the creditors under the absolute priority rule.

Landlords are treated fairly in subchapter V as well. They enjoy the same protections in subchapter V that they do in a traditional chapter 11, including the ability to seek relief from the automatic stay, the ability to force the debtor to decide whether to assume or reject the lease, and the ability to compel the debtor to pay postpetition rent as set forth in §365. In addition, landlords benefit from a more streamlined process in subchapter V as compared with a traditional chapter 11. The plan must be filed within 90 days of the petition, and subchapter V cases move forward faster and are concluded by confirmation or dismissal more quickly than in traditional chapter 11s.

A small business bankruptcy regime must set out which businesses are eligible. Some sort of line needs to be drawn that distinguishes small businesses from larger ones. It currently stands at $3,424,000. Subchapter V is centered around those businesses whose continued existence depends on the current owners remaining in place. These are the businesses whose value cannot be separated from those who own and run it any more than people can be separated from their shadows. But these businesses that depend upon a single owner-manager are often quite substantial. Indeed, even when small businesses are broadly conceived to include all businesses with 500 or fewer employees, 37 percent are owned by a single person and in 93 percent of these, this sole owner manages the business. *See* James Ang, Rebel Cole, and Daniel Lawson, *The Role of Owner in Capital Structure Decisions: An Analysis of Single-Owner Corporations*, 14 J. Entrepreneurial Fin. 1 (Fall 2010).

These businesses can carry substantial debt that can easily exceed the current subchapter V debt cap.

- A decent-sized restaurant or brew pub easily can cost several million dollars just to build and equip. A single unforeseen setback such as a catastrophic storm or an outbreak of food-born illness can sink the entire enterprise.
- A general contractor for a commercial building often enters into a web of contracts that exposes it to multi-million-dollar liabilities if things go wrong. Even a single subcontractor can make a costly mistake, fail, and leave the general contractor responsible for fixing the mess.
- The owner of a small manufacturing operation might have a plant with equipment that itself costs multiple millions. When such a manufacturer goes through a run of bad luck, it can face substantial mortgage obligations, environmental and tax liabilities, and unpaid bills from suppliers.
- Personal service firms, such as medical practices or small law firms, can have substantial debt and reverses that leave them unexpectedly without the revenues that were reasonably anticipated. A scrupulously honest owner can have the bad luck to hire one bad actor, and that single employee can embezzle so much that the entire business is put at risk.

Without the ability to reorganize under subchapter V, such firms will likely face liquidation, an outcome that will yield little, if anything, to creditors, particularly trade creditors, and employees.

Many businesses eligible for relief under subchapter V are similar to family farms that are permitted to reorganize under chapter 12. In 2019, Congress enacted a permanent increase to the chapter 12 debt cap. That cap currently stands at $12,562,250. It is hard to identify a principled reason for the subchapter V debt limit being only a small fraction of the one for chapter 12.

Subchapter V is a relatively new statute, and as in any such statutory scheme, it may require some adjustment as cases reveal imperfections, uncertainties, or abuses in its operation. Nothing in our experience, however, suggests that increasing the cap would be a source of mischief. We believe that increasing the cap gives small businesses a viable remedy that is proving to be highly workable for those businesses that subchapter V was intended to serve, as well as valuable for their stakeholders.

There are other areas of bankruptcy and bankruptcy-adjacent law where incremental reform is worth studying as well. Consider, for example, an issue with respect to state insurance insolvencies that has only recently captured attention.

Under state insurance insolvency regulation, the United States can itself have a claim. The United States Code contains a provision that gives the United States an absolute right to priority over other creditors. 31 U.S.C. §3713. The statute provides nothing in the way of providing procedural rules to implement this priority. In bankruptcy cases, the Bankruptcy Code displaces the statute with rules that protect the priority right of the United States without disrupting the process. There is, however, no comparable process for state insurance insolvency proceedings.

When the United States fails to appear in a state insurance insolvency, receivers may be reluctant to liquidate the assets, as the receivers themselves are potentially personally liable if the United States later appears and makes a claim. Section 3713(c) provides that "a representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government."

To be sure, courts have held that the representative "must have knowledge of the debt owed by the estate to the United States or notice of facts that would lead a reasonably prudent person to inquire as to the existence of the debt owed before making the challenged distribution or payment," United States v. Coppola, 85 F.3d 1015, 1020 (2d Cir. 1996). Moreover, the Supreme Court has held that the McCarren-Ferguson Act may allow for state insurance insolvency statutes to "reverse preempt" the Federal Priority Act. See U.S. Dept. of Treasury v. Fabe, 508 U.S. 491 (1993). The reach of this precedent, however, is unclear. Representatives of insolvent insurance companies may be reluctant to expose themselves to liability when there is any doubt.

The absence of any special provision for state insurers is not a deliberate policy choice by Congress. Instead, 31 U.S.C. §3713 merely reflects the ancient nature of the law. The Federal Priority Act now found in 31 U.S.C. §3713 existed in substantially similar form in Revised Statute §3466. Revised Statute §3466 is in turn based on the Act of March 3, 1797, §5, 1 Stat. 515. Like other eighteenth century congressional enactments, it was skeletal and underdeveloped and has remained that way in subsequent enactments.

Congress did address the difficulties Revised Statute §3466 posed in bankruptcy cases in the Bankruptcy Reform Act of 1978. See Bankruptcy Reform Act of 1978, §322, Pub. L. No. 95-958, 92 Stat. 2679 (1978), but as far as we know Congress has not focused on the difficulties the Federal Priority Statute poses in other insolvency regimes. Hence, it is reasonable to consider legislation that addresses this difficulty in the case of state insurance insolvencies.

There are also other areas where more ambitious reform might be possible. The success of Chapter 11 has led to the modernization of insolvency laws across the world. Chapter 11 has been widely imitated. Businesses with operations both in the United States and abroad often choose to file in the United States and reorganize under Chapter 11. Large transnational businesses, however, now have a choice among jurisdictions, and some find advantages in reorganizing elsewhere. Examination of these other regimes points to one way in which existing bankruptcy law is too inflexible.

In the United States, it is not possible to restructure principal or interest payments on a bond issuance outside of bankruptcy without the unanimous support of the bondholders. The restructuring cannot take place outside of bankruptcy because of the Trust Indenture Act. It can take place in Chapter 11, but at the cost of involving all the other creditors and bringing major disruptions to all constituencies from suppliers to landlords to workers.

By contrast, in the United Kingdom, it is possible to reorganize a single tranche of funded debt without affecting the business's other creditors, its workers, or any other aspect of its operations. The English scheme of arrangement allows for a limited restructuring of discrete tranches of debt with just enough judicial oversight to ensure that the supermajority of bondholders is not taking advantage of the dissidents.

Adding a comparable, limited restructuring regime to the Bankruptcy Code that allows bondholders to restructure their debt without disrupting the rest of the business appears to be a sensible bankruptcy reform.

As always, the National Bankruptcy Conference stands ready to help provide advice or technical assistance with respect to these issues or other questions of bankruptcy reform.