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HEARING ON OVERSIGHT OF BANKRUPTCY LAW & LEGISLATIVE PROPOSALS

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, COMMERCIAL AND ADMINISTRATIVE LAW

HOUSE COMMITTEE ON THE JUDICIARY

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TESTIMONY OF AMERICAN BANKRUPTCY INSTITUTE

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BERNSTEIN SHUR; PORTLAND, MAINE

ABI PAST PRESIDENT AND CO-CHAIR, COMMISSION TO STUDY THE REFORM OF CHAPTER 11

Chairman Cicilline and Ranking Member Sensenbrenner,

Thank you for inviting me to present the views of the American Bankruptcy Institute (ABI) in support of several bipartisan bankruptcy measures now pending before the subcommittee. ABI is the world's largest association of professionals practicing in the area of corporate restructuring and personal bankruptcy, with nearly 11,000 members worldwide. ABI is non-profit and non-partisan, and was founded in 1982 in part to provide unbiased analyses to Congress, administrative agencies and the public. Our website, ABI.ORG, contains a wealth of news, information, case law, analysis and scholarly research, updated each day.

I served as President of ABI from 2009-10 and later as Co-chair of ABI's Commission to Study the Reform of Chapter 11 (Chapter 11 Commission). My full bio is attached to these remarks. I was also retained, prior to the commencement of the Title III cases under PROMESA, to serve as a fee examiner with respect to certain professionals retained by the Financial Management and Oversight Board for Puerto Rico (FOMB), and, following the appointment by the court of a fee examiner for the Title III cases, Brady Williamson, I have continued to advise the FOMB with respect to the review of fees and expenses of professionals retained by the board with respect to fees and expenses incurred in connection with non-Title III services. In my testimony with respect to PRRADA below, I do not testify on behalf of the FOMB, but only as a representative of the ABI, and my statements do not reflect the views of the FOMB or any member thereof.

The 400-page report of the Chapter 11 Commission was the product of three years of study by two dozen thought leaders in the community on how best to improve and modernize a U.S. Bankruptcy Code that was nearly 40 years old at the time. Since its issuance in 2014, the Chapter 11 Commission report has been an influential resource for stakeholders and cited by numerous federal courts, including the U.S. Supreme Court. The Chapter 11 Commission continues to inspire legislative reform, including at least one of the bipartisan, bicameral items on today's agenda, which ABI is pleased to support.

Today I will address four bipartisan measures: the "Family Farmer Relief Act of 2019", the "Small Business Reorganization Act of 2019", the "Honoring American Veterans in Extreme Need Act of 2019", and briefly, the "Puerto Rico Recovery Accuracy in Disclosures Act of 2019". I will also offer for the record with your permission, supporting letters from the American College of Bankruptcy on several of these items.

We also understand the Subcommittee has an interest in the important interface between the Bankruptcy Code and student loan debt. This significant economic problem is the subject of the first set of reform recommendations contained in the Final Report of the ABI Commission on Consumer Bankruptcy (Consumer Commission) issued on April 11 of this year, and we are pleased to be able to share those recommendations today, as part of my written statement.

<u>Family Farmer Relief Act of 2019 (H.R. 2236; S. 897)</u>

This bipartisan and bicameral legislation would increase the debt limits for the filing of Chapter 12 cases from the existing limits (now $4,153,150 for farmers) to $10 million.

Since its enactment in the midst of the severe farm crisis in 1986, Chapter 12 has been a useful and durable support for the cyclical economic challenges faced in American agriculture, roiled by fluctuating land values, swings in commodity prices, weather calamities and adverse trade policies made by government. In 2005 Chapter 12 was made a permanent part of the Bankruptcy Code's protections and expanded to include family fishermen. Chapter 12 has not only assisted family farmers in their efforts to successfully reorganize debts in bankruptcy court, it has perhaps more significantly provided a framework that encouraged stakeholders to reach agreement on debt restructuring outside the expense of the formal bankruptcy process.

Farming is not just a job; it is a way of life in farming communities that exist in nearly every Congressional district in the country. There is great value for rural communities who are able to retain entrepreneurs involved in family farming.

At the outset in 1986, Congress established a debt limit of $1,500,000 for eligibility. Since then, the debt limits have been adjusted upward, but limited to changes in the Consumer Price Index. In 1986 the vast majority of farms were owned and operated by members of a single or extended family. That remains true, as today's farms are owned and operated by the later generations of those families who managed to survive cycles of severe economic stress, with the help of Chapter 12. However, today's farming operations are much larger and operated by fewer families than in the 1980s. Farming has progressed from intense labor with small equipment in the 1980s to limited labor but much more expensive technology, including computers using expensive GPS capability. Debt amounts are much larger today, given capital requirements for farm land, equipment and inputs.

Relative to 1986, and in nominal dollars, production expenses in agriculture have increased by 198 percent and farm debt has increased by 182 percent, while net cash income has experienced only half of that growth, according to the American Farm Bureau. As a result, the liability cap under Chapter 12 does not align with the modern credit and risk environment associated with family farming.

Rep. Delgado's bill (H.R. 2336), which now has 23 bipartisan cosponsors, is a needed improvement if Chapter 12 is to continue to serve its salutary proposes for family farmers and Main Street businesses who work in concert in rural communities.

The Family Farmer Relief Act of 2019 would allow more family farmers to seek relief under the program by raising the Chapter 12 operating debt cap to $10 million. Lifting the liability cap and giving more farmers an opportunity to qualify for Chapter 12 bankruptcy provides the restructuring and seasonal repayment flexibility that many farmers need in today's lagging farm economy and will help to align bankruptcy law with the scale and credit needs of U.S. agriculture.

Farmers and ranchers have experienced what turbulent economic headwinds do to the livelihoods of families and our rural communities. No region of the country is unaffected: in the last 10 years, more than 200 Chapter 12 cases have been filed in New York, Texas, Michigan, Puerto Rico and Florida. More than 300 have been filed in Wisconsin and Georgia, and more than 400 in California.

This commonsense, bipartisan legislation will give more family farms an opportunity to reorganize their business while avoiding critical disruptions in our national agriculture supply chain that can affect every American. To be sure, while there certainly have been years where farmers faced greater immediate financial challenges than 2019, uncertainties in both the trade and commodities markets make this an ideal time to reset Chapter 12 before a crisis arrives. ABI supports this legislation and urges its enactment in this Congress.

Small Business Reorganization Act of 2019 (H.R. ; S.1091)

Chapter 11 of the Bankruptcy Code has long been of great value in preserving going concern value, jobs, and maximizing creditor recoveries for many businesses. But as the Chapter 11 Commission found, the law no longer works well for businesses of smaller size.

Small businesses are the entities that produce job creation and a dynamic economy, but are also most likely to experience financial distress.

As Congress looks to find ways to help small businesses enter the marketplace and create new jobs, it also should focus on helping existing businesses succeed and save jobs that otherwise would be lost if those businesses closed their doors. The "Small Business Reorganization Act of 2019" (SBRA) is a good start and we thank Rep. Cline and Rep. Cicilline for sponsoring it in the House. With modest improvement, it can be even more effective in service to the nation's economic backbone.

The deficiencies in existing U.S. bankruptcy laws were highlighted and examined extensively during a three-year study process undertaken by the American Bankruptcy Institute's Chapter 11 Commission. The Commission was made up of 22 of the country's most respected and experienced bankruptcy professionals, and the Commission process involved approximately 150 bankruptcy professionals working on advisory committees and almost 90 witnesses who testified at 17 public hearings. The Commission endeavored to include all perspectives and stakeholders in the conversation, including businesses of all sizes, secured lenders, bondholders, unsecured trade creditors, and employees. Consequently, the Commission's findings and recommendations are the result of a holistic study that seeks to improve the U.S. bankruptcy system for all stakeholders.

The Commission's study concluded that Chapter 11 no longer works efficiently or effectively for many financially distressed companies or their creditors. Although the identified issues permeate chapter 11 bankruptcies, the testimony before the Commission suggested that the chapter 11 process simply does not work at all for small- and medium-sized businesses. Witnesses testified how small- and medium-sized businesses no longer use chapter 11 to try to save their businesses; rather, for the most part, these companies file bankruptcy knowing the business will not survive. And the numbers support this testimony. For example, for Fiscal Years 2008-2015, over 18,000 small businesses filed a chapter 11 case; only about 27% of those companies confirmed a reorganization plan. Notably, these numbers do not account for the small businesses that are struggling but do not even try to reorganize under chapter 11 because the Bankruptcy Code is seen as broken and unworkable for those kinds of businesses[1].

Chapter 11 doesn't work for small and medium-sized businesses because the Bankruptcy Code (a) places unrealistic and artificial deadlines on small- and medium-sized businesses, which do not give these companies an opportunity to restructure; (b) imposes substantial and costly disclosure and reporting requirements on these companies; (c) does not provide any tools that can help small businesses—whose owners may be unsophisticated in finance, business plans, or restructuring issues—create and implement an effective

[1] Indeed, in FY 2018, there were only 1,335 small business chapter 11 cases filed nationwide. The number of cases filed under the current small business chapter 11 has declined for eight consecutive years. Source: Federal Judicial Center Integrated Data Base.

reorganization plan; and (d) makes it difficult for a small business owner to maintain an ownership interest in the business under the current Chapter 11.

Providing a small- or medium-sized debtor with the time and the tools to reorganize under the Bankruptcy Code allows individuals to retain businesses they have worked hard to build, while preserving the value of secured creditors' collateral. It keeps that business operating and acting as a customer or supplier to other small businesses, and it saves jobs. It also encourages owners of struggling businesses to seek the help they need or to enter into financing and other arrangements that may mitigate short-term problems, rather than deepening the company's longer-term financial or operational difficulties through delay. It also protects the rights of creditors in terms of notice, due process and fair and equitable treatment -- rights not present in potential state law alternatives

The SBRA could address many of the difficulties experienced by small business debtors, in large measure by applying the terms found in Chapter 12. However, the SBRA as currently proposed would apply to cases where a debtor has aggregate liabilities that do not exceed $2,566,050 (excluding debt owed to one or more affiliates or insiders). This debt limit, borrowed from the current definition of "small business debtor" in Section 101(51D) of the Code, is simply too low to provide meaningful help for small and medium-sized companies.

As in the case of family farms, most small businesses will have more than $2.7 million in total debt (secured, priority and unsecured). For example, in times of distress, a business will actually increase borrowings secured by the business assets in an attempt to remain afloat. Or one underinsured judgment in a products liability case, for example, could make a business ineligible for relief, when that relief is most needed. Accordingly, we think the debt limit proposed for a remodeled Chapter 12 ($10 million, as found in H.R. 2336) should be adopted as part of SBRA.

The ABI Chapter 11 Commission considered several analyses and empirical studies of Chapter 11 debtors' assets and liabilities found in the schedules of filed cases. The data revealed a natural breaking point at a $10 million threshold. The Commission then examined the types of businesses that might be captured by a definition that included companies with $10 million or less in assets or liabilities. They considered this question based on industry and geographic region, methodically walking through the different companies that could be captured by such a definition.

The Commission agreed that while public companies should be excluded from small business treatment no matter the size, that otherwise entities with $10 million or less in assets or liabilities corresponded most closely with businesses not well served by current U.S. bankruptcy law. We support this change to the SBRA.

Honoring American Veterans in Extreme Need Act of 2019 (H.R. 2938; S. 679)

The objective of the [Honoring American Veterans in Extreme Need (HAVEN) Act of 2019] is to secure the economic well-being of veterans and dependents who rely on disability compensation and may be experiencing financial hardship.

The problem is that under current bankruptcy law, disability benefits paid by the Department of Veterans Affairs [VA] and the Department of Defense [DoD] are included in the calculation of a debtor's disposable income, which increases the portion of the debtor's income that is subject to the reach of creditors. By contrast, current bankruptcy law explicitly exempts Social Security disability benefits from this disposable-income calculation. This disparate and unexplained treatment of veterans results from an apparent drafting error in the 2005 bankruptcy amendments. Unfortunately, it has resulted in significant financial hardship to some disabled veterans who have been forced to use benefits to fund repayment plans in Chapter 13 while being denied access to Chapter 7.

When a disabled veteran who has served his country has his or her VA disability benefits included in current monthly income (CMI) for purposes of the Chapter 7 means test, the likely result is that the veteran will "fail" the means test, while an identically disabled person receiving Social Security benefits can exclude the income and remain eligible for relief. This disparate treatment discriminates against veterans and should be fixed.

To eliminate this unequal treatment of disability benefits, the HAVEN Act would exclude VA and DoD disability payments made to veterans or their dependent survivors from the monthly income calculation used for bankruptcy means testing. Disabled veterans have earned their disability-related benefits in defense of our nation, and these benefits honor their service and the sacrifices that they have made. Forcing debtor beneficiaries to dip into these funds to pay off creditors not only dishonors their service and sacrifice, but also puts taxpayers at risk by increasing the likelihood that the beneficiary and his or her dependents will require public assistance. The HAVEN Act also complements recent congressional efforts to combat service member and veteran mental health issues, addiction, suicide, poverty, and homelessness — all of which are exacerbated by financial hardship.

The HAVEN Act has also been endorsed by a wide array of stakeholder groups, including the ABI. *Final Report of the ABI Commission on Consumer Bankruptcy, p 135-36 (2019).* Others include the American College of Bankruptcy, the Boston Bar Association, The American Legion, Veterans of Foreign Wars, Disabled American Veterans, Paralyzed Veterans of America, Iraq and Afghanistan Veterans of America, Wounded Warrior Project, Association of the United States Army, Association of the United States Navy, Retired Enlisted Association, Society of Military Widows, Veterans for Common Sense, and the U.S Army Warrant Officers Association.

We commend Rep. McBath and Rep. Steube for their recent introduction the HAVEN Act in the House. With the committee's permission, I would offer for the record letters in support of the HAVEN Act from the American College of Bankruptcy, as well as two recent articles published in the American Bankruptcy Institute *Journal*.

Puerto Rico Recovery Accuracy in Disclosures Act (PRRADA) of 2019 (H.R. 683; S. 1675)

This bill, introduced by Rep. Velazquez on behalf of a group of bipartisan cosponsors, would impose certain requirements on the payment of compensation to professional persons employed in cases commenced under Title III of the Puerto Rico Oversight Management and Economic Stability Act (commonly known as "PROMESA"). A similar bill in the Senate also enjoys bipartisan support.

Congress passed PROMESA in 2016 to set up a process to restructure the island's debts, pay off creditors, ensure efficient permitting of critical infrastructure projects, provide for fiscal responsibility and put the island on the path to financial recovery.

However, Congress failed to include one essential check in PROMESA: the requirement that the professionals compensated under PROMESA disclose any connections to the various creditors or other key stakeholders. This transparency requirement applies to every corporate bankruptcy under the Bankruptcy Code and Rules.

Under the bill, in a case commenced under section 304 of PROMESA, no attorneys, accountants, appraisers, auctioneers, agents, consultants, or other professional persons shall be compensated under section 316 of PROMESA (48 U.S.C. 2176) unless prior to making a request for compensation, such a professional person has submitted a verified statement conforming to the disclosure requirements of rule 2014(a) of the Federal Rules of Bankruptcy Procedure setting forth the professional person's connections with the debtor, creditors, any other parties in interest, their respective attorneys and accountants, the Oversight Board, and any person employed by the Oversight Board. Such statement shall include information on the identity of each entity or person with whom such professional person has a connection. Such professional person shall be required (1) to supplement such verified statement as additional relevant information becomes known to such person; and (2) to file annually a notice confirming the accuracy of such statement.

PRRADA should provide, in future proceedings, the same transparency and disclosure practices required by law in U.S. mainland bankruptcies. To the extent that it is consistent with current Bankruptcy Code requirements, it is a welcome change. However, because the PROMESA proceedings have been in place for some time, and the disinterestedness and other standards of the Bankruptcy Code were not requirements for retention of professionals at the outset of any of the Title III cases, the remedy provisions of PRRADA will have to be carefully considered, and likely amended, to prevent the inadvertent disqualification or necessary resignation of professional firms, including many local firms, that fairly and properly met the standards of retention when the Title III cases were commenced. Such an event could be highly disruptive of the current proceedings and the considerable progress made in those cases. Calibration of the application of the Bankruptcy Code standards going forward, when such standards did not previously govern, is essential to avoid interfering with that progress.

Student Loan Debt Treatment in Bankruptcy

U.S. student loan debt has ballooned from less than $400 billion in 2004 to over $1.5 trillion today, far surpassing credit card or auto debt. It is projected to swell to $2 trillion by 2022 and experts say a large portion of it is unlikely to ever be repaid. More than a quarter of borrowers are in delinquency or default. Student over-indebtedness has significant adverse consequences for the national economy as well. High levels of post-secondary education debt correlates with lower earnings, lower rates of home ownership, fewer automobile purchases, higher household financial distress, and delayed marriage and family formation among other ripple effects.

In the 1970s, policy makers were concerned that students would take out numerous loans and then seek to discharge them in bankruptcy after graduation. As a result, lawmakers added a stipulation that student loan borrowers would have to wait at least five years after they began repayment before they could be discharged in bankruptcy. In 1990, that waiting period was increased to seven years. Almost a decade later, the rules changed again, and now people with federal or private student loans can discharge their debt in bankruptcy only if they can prove their loans pose an "undue hardship." But what one bankruptcy judge finds to be an undue hardship may not be to a judge across the country, or in the same circuit, or even in the same court house.

Congress has never spelled out what that term means, and lawyers and advocates say this uncertainty leads to unfairness in the courts and a reluctance by financially distressed borrowers to even consider bankruptcy as an option. A number of voices in Congress have joined law scholars in calling on the U.S. Department of Education to establish clear rules around when borrowers are eligible to discharge their student debt in bankruptcy.

The ABI's Consumer Commission studied this issue as well from 2017-19 and unanimously recommended a series of statutory amendments to Sections 523(a)(8) and 1322, as well as calling for the Department of Education to promulgate bright line rules in cases of disability, poverty and the allowance of alternative repayment plans. The Consumer Commission further recommended that the *Brunner* test on "undue hardship" be clarified, and that student loan debt be permitted to be separately classified in Chapter 13 plans.

Significantly, the Consumer Commission weighed the rationale for student loan dischargeability against the current and projected student debt landscape. "The Commission considered but rejected the notion of making student loans freely dischargeable like any other debt, concluding that the rationales supporting nondischargeability remain valid". *Final Report of the ABI Commission on Consumer Bankruptcy*, p. 6 (2019). Instead, "[T]he Commission's recommendations are intended as a package and represent a practical, middle ground approach that will provide meaningful changes while respecting the traditional protections for student loans".

Thank you for the opportunity to appear before the Committee today. The ABI is ready to assist the Committee and staff on these important bankruptcy proposals.