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Bankruptcy Law

Representing the 'Small Business' Bankruptcy

Opportunities and risks abound

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Representing the small business debtor successfully can be quite challenging. There are potential benefits for electing to file a small business bankruptcy, however, such a filing is not devoid of risk — especially if there is a question as to whether the debtor will be able to file a plan within the strict statutory deadlines.

Typically, whenever the chief executive officer and/or shareholder of a company enter an attorney's office to discuss financial problems, the company has been undergoing problems for some time. And the attorney needs to be prepared for the additional emotional element when an individual who operates a small business walks through the door.

In all likelihood, they have never done anything else, and often cannot envision themselves as able to do anything else. While they might have some understanding of what caused the financial difficulty, their emotional involvement limits that understanding, which frequently is not well developed or even correct.

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The decision to openly discuss those problems with an attorney in many cases only occurs after running head-on into a "wake up" event. Wake-up events may be, for example, judgments entered or checks bouncing due to the execution by a judgment creditor or taxing authority.

The debtor must be made aware of the risks, potential benefits and costs of filing for bankruptcy. Prior to completing the initial consultation, fees must be discussed. The debtor must recognize that the bankruptcy process is not an inexpensive course of action. Even in a small business bankruptcy, fees can run anywhere from $7,500 to $50,000.

Typically, in a large business, attorneys and accountants may be on staff. The CEOs and shareholders are well aware of the issues and potential advantages and disadvantages of filing a bankruptcy. This awareness comes much later to your typical small business debtor.

The attorney's initial task should be to focus on the business. A thorough understanding of the debts and the assets must be quickly obtained. Is there really potential for a successful reorganization? This needs to be handled with sensitivity. If there is no hope that the business can be reorganized, it is in the client's best interest to concede and move on. All too often, Chapter 11 bankruptcies are filed and individuals go forward without any potential of success, not having the benefit of closure until a substantial amount of time passes, lengthening the time and extent of emotional turmoil.

The best method to help clients recognize whether a successful reorganization is feasibile is to suggest they seek appropriate guidance from an accountant and/or business consultant. An attorney should not accept employment as counsel for a small business unless the client is willing — prior to the bankruptcy — to have an accountant independently review the foundation of its financial status. They must understand the reasons for their financial problems and the potential for a successful outcome.

Counsel must have a 12-month projection prepared with the assistance of an accountant or other financial professional. That 12-month initial budget is a requirement for filing with the initial operating report by the U.S. Trustee's Office. It is a document to which much thought and attention must be given prior to the decision to file a bankruptcy.

Accountants and business consultants must properly understand their role. They are not expected to initially be an advocate for the position of the owner; they must perform an independent review of income and expenses for the last few years and attempt to assess what factors caused financial difficulties. They should consider potential changes, which could reverse negative trends.

Accountants and business advisers should understand some basics of bankruptcy law. For example, the adviser must recognize the fact that a business

can reject executory contracts, and he must understand the potential benefits of rejection. Very often, it is the accountant who discerns obvious issues that need to be resolved to have a successful reorganization.

While these same issues may not have been obvious to the owner, it also could be that the owner was unwilling to face them. For example, leased space may be much more than is required or cost much more than its comparative value in the marketplace. I have seen small business entities save several thousand dollars each month by rejecting a lease and moving into a smaller facility.

Other potential executory contract strategies may include giving up certain leased and financed equipment. Defaulting in certain obligations may very well be in the debtor's best interest. The treatment of secured and unsecured creditors will form the basis of a plan. Many times a small business crosses the threshold into financial difficulty due to attempts to expand too fast. What can and will be successful is retooling at the lower level where they first met success.

Prior to the decision to file the bankruptcy, a consultation should take place with both the debtor and debtor's chosen accountant/business adviser. By that time, counsel will have completed a separate analysis. Debtor and counsel will now be ready to make the final determination.

Small Business Election

The last meeting between the professionals must confront the decision to file bankruptcy. At that time, an analysis of assets, liabilities and potential for success already will have taken place. A 12-month proposed budget will be in place and certain cost-cutting factors will have been identified.

The next step is to ascertain that, after all the information has been gathered, the debtor qualifies as a small business debtor.

A small business debtor is defined by 11 U.S.C. 101 (51C) as:

> a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed $2,000,000.

If a debtor qualifies, the debtor has the ability to elect to be considered a small business under 11 U.S.C. 1121(e) of the Bankruptcy Code. There is no requirement that they file a small business bankruptcy; it is merely an option.

In the event the election is made, the case is put on a "fast track" and treated differently than a regular Chapter 11 case under the code. This can be extremely beneficial in minimizing costs for a small business debtor.

The cost factor is probably the primary reason for the enactment of this option and its utilization. Pursuant to §1121(e)(1), "only the debtor may file a plan until after 100 days after the date of the order for relief under this chapter."

In all other Chapter 11 cases, other parties cannot file a plan until 120 days after the date of the order for relief under this plan. The debtor is thus compelled to file its plan earlier, if the debtor does not want to have a potential creditor plan filed first.

In addition, under §1121(e)(2), "all plans shall be filed within 160 days after the date of the order for relief." The plan must be filed within 160 days. Chapter 11 filings for larger businesses have no similar deadline.

The court can only reduce those periods for cause, provided that the request is made within those periods of time. There is no provision to increase the 160-day period. The 100-day period only can be increased if "caused by circumstances for which the debtor should not be held accountable."

One of the cost-saving measures is the fact that the appointment of a creditors committee is not an automatic requirement of the United States Trustee. Even if there is interest in a committee, the court can order that the committee *not* be appointed.

Lastly, and noteworthy, is the fact that a separate hearing to approve the disclosure statement is not mandatory in a small business case. 11 U.S.C. 1125 (f) provides that:

> (1) the court may conditionally approve a disclosure statement subject to final approval after notice and a hearing;
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> (2) acceptances and rejections of a plan may be solicited based on a conditionally approved disclosure statement as long as the debtor provides adequate information to each holder of a claim or interest that is solicited, but a conditionally approved disclosure statement shall be mailed at least 10 days prior to the date of the hearing on confirmation of the plan; and
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> (3) a hearing on the disclosure statement may be combined with a hearing on confirmation of a plan.

A review of these sections referenced above emphasizes the need for substantial prebankruptcy planning, if not substantial optimism that the bankruptcy can proceed quickly and smoothly.

This may also require prebankruptcy discussions with creditors, especially creditors with a security interest in cash collateral. These streamlined provisions make the small business Chapter 11 filing extremely attractive, substantially reducing the cost of the typical Chapter 11. A debtor may not be burdened with the costs of counsel for the creditors committee or a separate hearing and notice requirements for approval of the disclosure statement and confirmation.

Furthermore, it places substantial pressure on counsel to move expeditiously, usually providing for a more efficient handling of a case. Lastly, it brings a greater sense of certainty for an expeditious resolution to the small business debtor in extreme financial distress. It is always gratifying when a principle can again begin to take a reasonable salary and pay bills once the petition has been filed.

Current Case Law

There has not been a significant amount of litigation concerning the small business debtor provisions of the Bankruptcy Code. Small business

debtors cannot afford to engage in protracted and expensive litigation.

A few of these cases deal with the issue of a debtor violating one of the timeframes set forth above. The courts have been extremely consistent and strict with regard to the enforcement of the deadlines.

In *In re Western Steel & Metal, Inc*., 200 B.R. 873 (Bankr. S.D. Ca. 1996), the court dismissed a small business Chapter 11 on motion of a creditor. The creditor had filed the motion to dismiss under §1112(b)(4) due to the failure to file a plan within 160 days and also for cause under §1112(b)(1), (2) and (3). The debtor, seeking to withstand the motion, moved to withdraw the small business election and opposed the motion.

The court dismissed the case, finding that the plain language of the statute required the result. It is interesting to note that the court observed that the debtor had not sought to increase the period. In one segment of the opinion, the court appears to agree that there is no statutory authority for an extension and in another part references the debtor's failure to seek an extension pursuant to Fed. R. Bankr. P. 9006(b), which generally deals with expansion of time.

Furthermore, the court noted that while the debtor had sought to withdraw the small business election, this issue had not been raised for the court to consider. The court further held that the failure to file a plan was cause under §1112(b).

Similarly, in *In re Win Trucking, Inc*., 236 B.R. 774 (Bankr. D. Ut. 1999), confirmation of a plan was denied, on objection by the United States Trustee when the plan had not been filed within the 160-day period provided by statute. The deadline could not be avoided by withdrawing the small business election without notice, motion or order.

The debtor had filed the plan over 300 days after the order of relief. After that time, it sought to file a withdrawal of its small business election. Numerous reasons for the delay were asserted, including a change in venue, new counsel involvement and lack of knowledge, along with personal problems of an attorney.

This court did note that "[U]nlike the time limits fixed for filing a plan in a single asset real estate case … §1121(e) contains no provision for extending the 160-day period for plan filing." While the court cited *Western Steel*, it did not address the bankruptcy rule issue raised in that case regarding other potential provisions for an extension.

The court squarely dealt with the issue of an attempted withdrawal of the small business election. Finding no cases dealing with this issue, it cited cases dealing with the withdrawal of elections by creditors concerning claims or by debtors in Chapter 12. While the court could not find any direct statutory authority, the court did assert that there is sufficient "analogous case law" to support the ability to withdraw an election.

A withdrawal would only be allowed upon an application being filed within 160 days (the time fixed by §1121(e)(2)), good cause shown and in the absence of any prejudice to any party. As the withdrawal in this case was beyond the 160-day period, the court could not allow the withdrawal as a defense to the denial of confirmation. Nor was the court swayed by any arguments of excusable neglect under Fed. R. Bankr. P. 9024 or "harmless error" under Fed. R. Bankr. P. 9005.

Four other cases dealt with issues involving small business bankruptcies. *In re Haskell-Dawes, Inc*., 188 B.R. 515 (Bankr. E.D. Pa. 1995), dealt with a request by the debtor to dispense with the appointment of a creditor's committee. The debtor had cited the increased costs, delay and the policies of the small business election in support of its motion.

Three creditors had objected. These were also the only three debts disputed by the debtor. After reviewing the statute and certain legislative history, the court did not find that debtor had asserted cause to have the court preclude the formation of a committee.

The court did reference the fact that no financial data of any kind was presented with regard to reorganization efforts or the cost effect on creditors. No evidence had been presented with regard to the asserted intent to cram down the two largest creditors, both of whom had filed objections. In the event that there was to be abuse by these particular creditors in using their position on the committee for their own individual interests, the debtor could seek to have them removed.

While the court certainly recognized the policies behind the act in keeping costs down, it seems the court was simply not impressed with the proofs adduced at the hearing concerning the potential plan of reorganization and potential adverse effects/costs of appointing a committee.

In Re Aspen Limousine Service, Inc., 187 BR 989 (Bankr. D. Col. 1995), was the only case dealing with the scheduling of the streamlined procedure — dispensing with the need for a separate disclosure statement hearing. It also dealt with issues concerning a creditor's competing plan.

The debtor had timely filed its plan and disclosure statement, providing for a 100 percent dividend to creditors. It was conditionally approved and had been sent out to all creditors.

Thereafter, a creditor filed a liquidating plan providing for 100 percent payment to creditors. The court had to deal with the "inexplicable and seemingly absurd results" which may occur "when all of the time lines and rights afforded to small business debtors and creditors, or other parties interest, by Sections 1121 and 1125 are applied."

The debtor would not have the opportunity to proceed with its plan in a proper fashion. In order to reconcile the provisions, the court looked to the general powers of the court pursuant to §105(d)(2). While the creditor's competing plan and disclosure statement could be conditionally approved and treated on an accelerated basis, the court set forth a sequential process, which would provide primacy and a head start to the debtor's plan.

Most recently, in *In re Coleman Enterprises, Inc*., 275 B.R. 533 (B.A.P. 8th Cir. 2002), the Bankruptcy Appellate Panel affirmed a Bankruptcy Court decision holding an election to qualify as a small business was void and of no force and effect when the statutory limits on debts were exceeded.

The case would, however, continue as a Chapter 11. It is interesting to note that the debtor had not timely filed its plan, and a creditor had filed a plan. The debtor filed a motion to dismiss, which was denied.

Lastly, *In re Pineloch Enterprises, Inc*., 192 B.R. 675 (Bankr. E.D.N.C. 1996), provides that a flat-fee arrangement in a small business Chapter 11 case, established at the beginning of the case, could be approved. ■