Office of Advocacy

TESTIMONY

of

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before the

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
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The Bankruptcy Reform Act of 1999, H.R 833

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Good Morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to testify today before the Subcommittee concerning the Bankruptcy Reform Act of 1999, H.R. 833.

My name is Jere W. Glover and I am Chief Counsel for the Office of Advocacy at the U.S. Small Business Administration. Congress established the Office of Advocacy in 1976, and its statutory mission is to represent the views of small business before federal agencies and Congress.(1) As Chief Counsel for Advocacy I am also charged with monitoring federal agencies' compliance with the Regulatory Flexibility Act (RFA)(2) as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (3)

In addition, I am charged by Congress to monitor and report on the availability of capital and credit for small businesses. To fulfill this mandate, the Office of

Advocacy has undertaken a series of studies analyzing bank lending to small businesses. The studies are titled, "Small Business Lending in the United States," "The Bank Holding Company Study," and the "Micro-Business-Friendly Banks in the United States" study. This year we have added the study, "Small Farm Lending in the United States."(4) In addition, we have funded with the Federal Reserve Board two surveys entitled, "The National Survey of Small Business Finances." As business bankruptcies and failures are also part of the access to capital equation, we have also funded research on how bankruptcies affect small businesses.

Before discussing the Bankruptcy Reform Act of 1999, I would like to give a brief overview of how entrepreneurism is vital to the U.S. economy.

Entrepreneurism and the U.S. Economy

As I stated in testimony last year before the Senate, 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:

- Since 1992, more than three-fourths of all net new jobs has been created by small businesses.(5) While the Fortune 500's share of U.S. employment has declined steadily since 1968, small business entrepreneurs have filled the gap.(6)
- It is estimated that the fastest growing segment of the small business community, called "gazelles," numbers 355,846 businesses.(7)
- 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.(8)
- 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 higher rate than ever before.(9)

As businesses and our economy diversify we must also have an economy that is flexible enough to accommodate the new problems and issues faced by businesses as they start up, expand, contract, and close.

Last year, the U.S. economy set another record – **898,453 new firms with employees were created** -- an increase from the record set in 1997.(10) The strength of our economy lies in part from the technology boom sparked by the tens of thousands of middle managers taking up entrepreneurism after being downsized by large corporations in the early and mid-1990's.

In contrast, the number of business-related bankruptcies is at a historic low. Last year, of the 1.4 million bankruptcy filings, the number filed by businesses was 44, 367, the lowest number since 1981. Of that number, only 7,524 were business filings under Chapter 11. According to the American Bankruptcy Institute, "business bankruptcies have decreased by 31.6 percent since 1990, when they totaled 64,853."(11) If you assume that 90% of all business bankruptcy filings are filed by small businesses, then statistically, **small business bankruptcy filings in Chapter 11 accounted for less than one-half of 1 percent (0.48%) of the 1.4 million bankruptcy filings in 1998.**

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 in sustaining 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.(12) A recent study funded by the Office of Advocacy confirmed this and showed that 24 percent of entrepreneurs in bankruptcy have either started another business or plan to start another business.(13) Unlike some European and Asian 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.

Recently, studies have been undertaken in Europe and in Japan to understand the United States entrepreneurship system – in essence to find out what we are doing right. A study commissioned by EIM International of the Netherlands sought to understand the link between business failures and the ability of entrepreneurs to start again.(14) Recent research in Japan compares the financing systems in Japan with those in the United States.(15) The attached chart clearly shows the quick birth and growth rates of small companies in the United States in comparison with the much longer Japanese birth and growth rate. But it is also clear that bankruptcies and business failures are not an accepted part of the Japanese system. Business men and women who fail are stigmatized and are usually unable to continue in the business world.

The competitive fundamentals of our free market system allow not only for innovation and creativity but also for forgiveness that allows entrepreneurs a fresh start. As businesses are being driven toward technology and service-based industries and globalization our economy is diversifying. This poses new challenges, and perhaps unfamiliar problems for our business community. We need a bankruptcy system that is flexible enough to accommodate and work with these concerns and to recognize the changing nature of our economy.

Comments on the Bankruptcy Reform Act of 1999

Even though business bankruptcies are at a historic low, I am not advocating that the bankruptcy system is perfect. As our research has shown, the majority of bankruptcy filings are made by very small businesses. Many of the small business owners would benefit greatly from additional education and guidance on the bankruptcy process. 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. We applaud initiatives of some of the U.S. Trustees of the Department of Justice to help small businesses in this manner.(16)

As of this date, I believe that the proposals in H.R. 833 go too far in addressing the relatively small number of problem cases. Under the proposals, small business owners who are legitimately using Chapter 11 proceedings to reorganize their businesses may be forced into a premature dismissal or conversion or may have to expend vital resources to fend off challenges by any creditor for relatively minor procedural infractions.

As I mentioned above, there are many factors that are changing our economy and will require greater flexibility for small business debtors in bankruptcy. Two prime examples are the facts that our economy is moving from a manufacturing to a service and information base and that small businesses are taking advantage of a global marketplace. Small service business debtors may not have the real estate or manufacturing equipment assets typically available to other industries in reorganization efforts. Small business exporters may encounter international situations that present problems outside of the debtors' control. These businesses may require unique reorganization provisions in order to return to profitability. Under H.R. 833, the time and flexibility needed to address special circumstances will be severely restricted.

As I stated in my letter to the committee last year on similar legislation, the proposals 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. I believe that this is not the correct approach for this situation. As Congress passed the Regulatory Flexibility Act to require federal agencies to consider the effects of proposed regulatory actions upon small entities, we should adopt the same approach here.

I have serious concerns that Congress would adopt, for the first time that I can remember, more stringent requirements on small businesses than on large businesses. I believe that this is a dangerous precedent to set. In light of the historically low number of business bankruptcy filings and the quicker time that business bankruptcies are going through the system, the real question is whether these proposals are really necessary at all.

I believe the following provisions of H.R. 833 would improve the bankruptcy system for small business filers:

Flexible Rules for Disclosure Statement and Plan (section 401),
Standard Form Disclosure Statement and Plan (Section 403),
Uniform National Reporting Requirements (Section 404), and
Uniform Reporting Rules and Forms for Small Business Cases (Section 405).

These sections would greatly benefit both small business debtors and creditors. They offer flexibility and provide very small business filers with the essential documents necessary for bankruptcy reorganization. These combined with the educational courses and materials set up by the U.S. Trustees, would greatly enhance the ability of small businesses to focus on the future of their businesses. The only caution I have with standardized forms is that they may be drafted in a way that might discriminate against our growing service sector industries. We recommend that the SBA be consulted in the drafting of these documents.

The following are my recommended changes to H.R. 833 pertaining to small business debtors:

- Definitions (Section 402): I believe that the current definition of small business debtor should remain in effect. The definition should be less than $2 million in debt and the provisions should be elected by the small business. If the provisions are to be mandatory then I strongly recommend that the $2 million threshold be retained. This threshold would still capture more than 70 percent of the business filers as opposed to 85 percent that would be captured under the proposed $4 million ttabindex="230" hrefshold.(17) Congress should start with the smaller amount and then, if successful, the provision can be amended in the future.
- Deadlines and Prohibition Against Extension of Time (Sections 407, 408, and 409): These sections take away all discretion from the bankruptcy judge by setting mandatory time limits and curtailing the extensions of time. Chapter 11 was designed to be flexible, allowing the business to reorganize in the best possible way. As our economy is diversifying and our small businesses are pursuing international trade opportunities, there will be many new factors and challenges for businesses to overcome in order to reorganize effectively under our bankruptcy laws. I believe that the bankruptcy judge is the best individual to decide the timeline of a particular business bankruptcy based upon the complexity of the case, the regional economic factors and resources of the business to achieve

reorganization. Based upon the judge’s expertise, he or she would be able to calculate appropriate deadlines and extensions.

- Expanded Grounds for Dismissal of Conversion and Appointment of Trustee (Section 413): Under these proposed amendments, small business entrepreneurs must attempt to comply with all of their additional duties and filing requirements in a shorter time frame while continuing to run their businesses. Since any party in interest may file , the slightest infraction or delay may elicit a creditor to petition the court for dismissal or conversion of the small business bankruptcy. As is common in small business bankruptcies, there are typically one or two secured creditors and many unsecured creditors (many of them small businesses). Unfortunately, one unintended result of the proposals is that they would give the creditors with the most resources the advantage of being able to file for minor procedural deficiencies. Such provisions may cause the debtor to spend considerable resources in court. In addition, small business creditors may not have the resources to actively participate in such proceedings. I strongly recommend, if the grounds for dismissal or conversion are expanded, that only the court, own its on motion, or the U.S. Trustee, be able to bring motions on procedural grounds.

With regard to other provisions of H.R. 833, I believe that Section 206, regarding Creditors and Equity Security Holders Committees, should be amended to allow for any small business unsecured creditor that wants to serve on a creditors committee to be automatically considered by the U.S. Trustee as part of a creditors committee.

Finally, I believe that this legislation, as drafted, could have a chilling effect on entrepreneurism in the United States. Our free-market economy encourages entrepreneurs to take challenges and face risks in order to succeed. Our strong economy is evidence of our entrepreurial base. As I have previously stated, more than three-fourths of all net new jobs created since 1992 were created by small businesses.

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.

Conclusion

While I agree that the bankruptcy system is not perfect with regard to business bankruptcies, I believe that these proposals go too far in addressing the problem. It is clear from the statistics that small business reorganizations have not imposed a critical burden on the bankruptcy system. As stated earlier, only 0.48 percent of all bankruptcy filings in 1998 can be considered small business-related reorganizations under Chapter 11. According to the U.S. Trustees, the time businesses spend in Chapter 11 has also 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. H.R. 833 has several provisions that address the need for more statistical data on bankruptcies. I support those provisions.

In sum, I recommend the following with respect to H.R. 833:

- Maintain the current definition of small business ($2 million in debt);
- Put aside the provisions requiring mandatory use of the small business provisions;
- 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;
- Do not codify additional duties of small business debtors; and
- If additional grounds for dismissal or conversion are to be added then only the court or the U.S. Trustees should be able to use those provisions.

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. 5 U.S.C. §601 et seq.

3. Public Law 104-121, 110 Stat. 857 (codified at 5 U.S.C. §601 et seq.).

4. The studies are available on SBA's Internet website at "archive.sba.gov/ADVO/stats/".

5. See Appendix A.

6. See Appendix B.

7. Cognetics, Inc., Cambridge, MA, tabulation for the Office of Advocacy, U.S. Small Business Administration (1998).

8. See Appendix C.

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

10. Preliminary statistics tabulated by the Office of Advocacy, U.S. Small Business Administration based upon statistics by the Department of Labor.

11. American Bankruptcy Institute press release, March 1, 1999.

12. See Fullenbaum and McNeill, *The Function of Failure*, prepared by M & R Associates, for the Office of Advocacy, U.S. Small Business Administration (Springfield, Va.: National Technical Information Service, 1994).

13. See Sullivan, Warren and Westbrook, *Financial Difficulties of Small Businesses and Reasons for Their Failure,* prepared for the Office of Advocacy, U.S. Small Business Administration (September 1998)

14. See Poole, Micronomics, Inc., *Business Failure and Entrepreneurship in the United States* (September 20, 1998).

15. Chart compiled by Professor Akio Nishizawa, Faculty of Economics Tohoku Univeristy, Kawauchi, Aoba-Ku, Sendai 980-8576, Japan. See Appendix D.

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

17. Small Business Proposals, National Bankruptcy Review Commission.

* Last Modified: 6/13/01