

# Chapter 11

## How to decide whether to declare bankruptcy

INTERVIEWED BY ROGER VOZAR

**A**lthough it's best used as a last resort, filing for Chapter 11 bankruptcy can offer struggling businesses a chance to restructure debt and emerge as successful entities, says Marc Merklin, managing partner at Brouse McDowell.

"Chapter 11 is a tool and not an end in and of itself," he says. "Businesses that go into it without knowing what they want to accomplish often flounder and fail because it's an expensive process. The longer it goes on, the greater the risks and costs. Companies that succeed have a specific goal and accomplish it as quickly as possible."

*Smart Business* spoke with Merklin about alternatives to bankruptcy and how to best utilize the Chapter 11 process, should it prove necessary.

### Are there options short of bankruptcy that should be considered first?

A workout is the best option because bankruptcy is expensive and risky. Try individual negotiations with the lender or creditors. Often with the lender there can be workout or forbearance agreements. They can be difficult to negotiate and disruptive to cash flow as lenders often add fees and expenses, as well as interest rate increases. Still, it's usually desirable to attempt to work that out before seeking Chapter 11 protection. Most lenders understand that Chapter 11 will not only delay the exercise of their remedies and cost additional funds, but also carry risks such as 'cramdown,' which means forcing creditors to accept a plan they oppose.

Even if you have multiple creditors, you can negotiate with a group of them through an out-of-court settlement,

whereby you give creditors notes for past due obligations and then amortize them. That can be difficult depending on the number of creditors.

### What are the differences between Chapter 7 and Chapter 11 bankruptcy filings?

Chapter 7 is liquidation, so there is a trustee appointed and the business is almost never sold as a going concern. Even if you're going to sell the business or liquidate it, it's often better to do it under Chapter 11 because the company can still manage itself rather than being liquidated by someone who has no knowledge of the industry or business.

The goal under Chapter 11 is to restructure and emerge. In the past five years, more Chapter 11 filings have been sales as going concerns rather than true reorganizations. In a sale as a going concern, assets go to a buyer who will operate them as the business but under new ownership and a new structure free of claims and debts. In a restructuring, the company largely emerges the same even if there is a new investor or new ownership.

### What are the benefits of filing Chapter 11 bankruptcy?

One is cramdown — the ability to force



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a payment plan when creditors are not willing to agree to a payment plan on their own.

The other is the ability to reject burdensome contracts that are causing huge losses. You can go into bankruptcy and reject that contract, convert it to a claim that you pay under a plan and not be bound by the contract. For example, if you're selling to a customer at a huge loss and they're holding you to that contract, you can reject that contract. They're going to have a claim, but it would be an unsecured claim under bankruptcy and might be paid at 10 cents on the dollar. The company is then freed from the requirement of producing those goods at a loss and can generate positive revenue going forward.

But while Chapter 11 can be a very useful tool, it's not the most desirable process because of the cost of accountant and attorneys' fees, as well as the risk for existing owners and equity holders in the company. Under the absolute priority rule in bankruptcy code, equity holders or owners fall last in line. They cannot retain their equity ownership without contributing new value to essentially 'pay' for those equity interests after confirmation of the Chapter 11 plan. ●