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Coming Back from a Business Bankruptcy

Chapter 11 doesn't have to be the last act of a company

By Martin C. Daks

For many business owners, the phrase Chapter 11, or voluntary bankruptcy, is the second-most fearful phrase they'll ever hear ("IRS audit" is probably the scariest). But local CPAs and other experts say that going Chapter 11 isn't necessarily a death sentence.

"Chapter 11 is an expensive way to contain costs," says Stephen B. Ravin, a partner with the law firm of Ravin Greenberg in Roseland, who focuses on insolvency. "But it can give a company a chance to reject, or get out of a burdensome lease and other agreements, and may also let it sell off inventory and other assets in an orderly manner instead of getting fire-sale prices in a court-ordered auction."

A company may also be able to sell off assets free and clear of any liens or other claims. But the legal and other costs associated with Chapter 11 can easily top $30,000 to $50,000 for a fairly quick bankruptcy that takes 18 months or less to resolve, he adds.

In New Jersey, 765 businesses filed for bankruptcy in 2005, up 11.8% from 684 in 2004, according to the American Bankruptcy Institute.

A company typically files Chapter 11 when it's in a Rocky Balboa kind of situation—on the ropes, but still showing the chance of gaining a second wind. Revenues may be falling while expenses are rising, leading to a mountain of unpaid bills.

In cases like these a Chapter 11 can offer a breather, putting a temporary hold on creditors' collection efforts. It can also give business owners a chance to renegotiate liabilities, like labor agreements, bills for inventory and other purchases. When it's done right, an enterprise can shed unneeded baggage and emerge as a leaner, more viable contender.

Something like that happened to a manufacturer in northern New Jersey that Ravin and his associate Sheryll S. Tahiri represented in a 2004 filing. The company was in a nonmonetary default, a kind of technical bankruptcy. Even though the firm could still pay its bills on time, it had run afoul of covenants, or financial conditions like the ratio of assets to liabilities, that were specified in a bank loan it had previously taken out.

"In this case the company was carrying more space than it needed, so it sold off equipment and real estate and is currently paying off all of its creditors," says Tahiri.

Sometimes, unanticipated shocks like an oil crisis can drive a sudden hike in operating and other costs, and can throw a company into a Chapter 11 situation without any warning. Think of the airline industry, which has suffered through a spate of bankruptcies and liquidations.

But other times a keen-eyed business owner can spot early warning signs, says Frederick L. Cohen, a founding partner of Cohen Friedman Dorman Leen in Clark.

"Issues like an inability to pay bills on time, falling behind on remitting payroll taxes, and taking longer and longer to collect on accounts receivables are all warning signs," he explains. "At that point a business owner needs to sit down with his or her advisors and see if the company can be rescued."

Robin Zielinski

Giannelli says it's important to have an "end game" to get rid of debt and emerge from Chapter 11.

Beginning in 2003, Cohen worked with a New Jersey-based printing business that had run up crippling levels of bank debt even as it incurred losses year after year on nearly $10 million of annual revenue.

"We advised management to file Chapter 11 as a way of stopping everything," says Cohen. "Then we sat down and analyzed the organization. The internal management structure was revised, inventory was trimmed and some people were laid off as part of the restructuring. We worked with bankers and major suppliers to get through this, and last year the company emerged from Chapter 11."

Among other significant changes, the firm strengthened its system of accounts receivables and other internal controls. "Previously, the company wasn't diligent about following up and collecting its receivables," notes Cohen. "Also, not enough attention was paid to the quality of the receivables. Fortunately those issues and others were eventually addressed."

But even a successful reorganization entails a lot of pain, cautions Cohen.

"It's an emotional time," he says. "An owner may have been dealing with vendors for 15 to 20 years, and now you're having trouble paying them. I've even seen some divorces following a bankruptcy—I don't know if the marriage was shaky to begin with, but the Chapter 11 just compounded the problems."

The situation's definitely not helped by the costs associated with a bankruptcy.

"A Chapter 11 can be financially difficult for a small business," says **Karen A. Giannelli**, a director with **Gibbons Del Deo** in Newark and chair of the company's Financial Restructuring & Creditors' Rights department.

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>
> *– Karen A. Giannelli, Director with Gibbons Del Deo*

She's also president of the Turnaround Management Association's New Jersey chapter. "Any activities outside of the normal course of business may be subject to court approval, and if a creditors' committee is formed [typically by the firm's 20 largest creditors], the Chapter 11 company has to pay the fees for any of its lawyers and other professionals. The costs can easily run into tens of thousands or even hundreds of thousands of dollars."

There's more, however. Giannelli points out that a company in Chapter 11 operates in a kind of fishbowl, where monthly cash receipts and disbursements have to be filed with the court and may be open to public inspection.

"It's important to have an 'end game' or written plan to extinguish your debt and to eventually emerge from Chapter 11," explains Giannelli. "The problem occurs when a company files for bankruptcy and doesn't have that game plan. That's what accounts for many failed Chapter 11s."

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