CRAIN'S
CLEVELAND BUSINESS
WWW.CRAINSCLEVELAND.COM

FINANCE

Chap. 11 can be used as mechanism to sell a business

For many small, mid-size companies, reorganization too expensive

By CHUCK SODER

4:30 am, March 22, 2010

Growing up, Mary Whitmer loved hearing her lawyer dad tell stories about how he helped all sorts of businesses — from grocery stores to coal mines to pallet manufacturers — emerge from bankruptcy intact.

Ms. Whitmer would like to tell such stories herself now that she is a bankruptcy attorney at Kohrman Jackson & Krantz PLL of Cleveland.

Since then, however, the process — governed under Chapter 11 of the Bankruptcy Code since 1978 — has grown too expensive for most small and mid-size businesses, she said. Now, those that do go through Chapter 11 often end up under new ownership, said Ms. Whitmer, who also is president of the Cleveland Metropolitan Bar Association.

"I just don't see Chapter 11 being a constructive way to reorganize unless you're a huge company," she said.

Chapter 11 filings in Greater Cleveland more than doubled last year, jumping to 53 in 2009 from 22 in 2008, according to statistics from the U.S. Bankruptcy Court of the Northern District of Ohio.

The increase indicates more area business owners are using the statutes as a way to sell their companies while under court protection from creditors, according to Ms. Whitmer and other area lawyers.

The section of the bankruptcy code is meant to give businesses time to reorganize debt and balance sheets and continue operating. By contrast, in Chapter 7 bankruptcy, a court-appointed trustee sells off a firm's assets piece by piece.

Owners of smaller firms often use Chapter 11 as a way to sell their business free of liens and claims because they can't afford to go through a lengthy reorganization, Ms. Whitmer said. For one, renegotiating contract terms, creating a revised business plan and finding new sources of capital can take a long time.

All the while, the filing company often ends up paying their own lawyer as well as attorneys representing the bank and a committee representing everyone else owed money. And good bankruptcy attorneys often charge more than $400 per hour, Ms. Whitmer said.

Still, for businesses that can find a buyer, filing for Chapter 11 is way better than having a court-appointed trustee take control of the business and sell its assets separately as part of a Chapter 7 bankruptcy, said attorney Jean Robertson, a bankruptcy partner at Cleveland's Calfee Halter & Griswold law firm.

"You want your management running the enterprise, not a bankruptcy trustee," Ms. Robertson said. "The goal here is to maximize value for creditors."

Desperate times ...

Adding to the number of new Chapter 11 filings is the fact that some well-managed businesses that happen to be short on cash can't find temporary financing to get them through the downturn because of the tight credit market, Ms. Robertson said. In normal times, she said, they wouldn't have to sell their companies.

"I'm seeing Chapter 11's that shouldn't be filing," she said.

Even during the Chapter 11 cases where companies are willing to take on the higher administrative costs related to restructuring — which increased as a result of changes to the federal bankruptcy code in 2005 — they can't find financing to keep them operating throughout the process because of the credit market, said Scott Opincar, a partner in McDonald Hopkins' business restructuring practice in Cleveland.

"Liquidating the business is simpler and quicker," he said.

Struggling firms that can't afford Chapter 11 do have other options, Mr. Opincar said. For one, over the past four years more companies, instead of filing for bankruptcy, have sought protection under receiverships in which they are put under the control of state courts or federal courts if they have substantial assets in several states. Receiverships are cheaper, and banks are becoming increasingly more comfortable with case law related to the process, Mr. Opincar said.

Filing companies also can use a method called the assignment for benefit of creditors, which involves putting the company in possession of a local probate court. Through that method, the company often is sold, but it can continue operating under current ownership with court approval, Mr. Opincar said. Such arrangements aren't popular in Ohio, but more companies might use the option as lenders grow comfortable with it, he said.

"Four years ago receiverships were not very common at all, but now they're very common," he said.

Consulting a bankruptcy attorney as soon as possible helps ensure that businesses thinking about filing for Chapter 11 have as many options as possible, said Daniel DeMarco, a partner with Hahn Loeser & Parks LLP of Cleveland. Tackling the problem early can help businesses line up a strategy before they lose any major customers, for instance, or trigger undesirable provisions in any of their contracts.

"We as attorneys always say, "Gee, I wish I could've started on this project a week earlier, a month earlier,' because there are always more options," Mr. DeMarco said.

A new start

Nationally, only about 10% to 15% of businesses filing for Chapter 11 continue operating, including those that undergo significant changes in ownership and management, Mr. DeMarco said. Anymore, cases in which a company's ownership and structure remain for the most part in place are "extraordinarily rare," he said.

However, he did represent Medina Glass Block Inc. during what so far has been a successful restructuring of the company.

The maker and distributor of glass block windows last summer emerged from Chapter 11 bankruptcy after about seven months of working with creditors and devising a plan that included closing seven stores and eliminating a division that sold and installed residential windows. It still sells residential windows through distributors, as well as commercial windows.

The company remains in "survival mode" but has been profitable every month since it emerged from bankruptcy, said Bud Kirkpatrick, chief operating officer. Medina Glass Block chose to restructure under its current ownership because, though profitable entering bankruptcy, the company had so much debt that selling would have left the owners with nothing, Mr. Kirkpatrick said. In the end, it was worth the massive attorney bills and the work sessions that sometimes lasted up to 20 hours, he said.

"It's a very expensive process, but the alternatives seemed more expensive," he said.

(Crain's Cleveland Business reporter Dan Shingler contributed to this story.)