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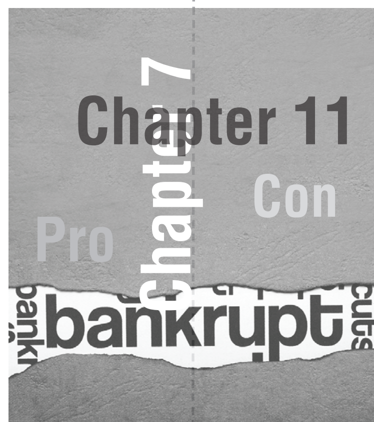
## Small Business Bankruptcy: Chapter 11 Pros and Cons

*By Frederic P. Schwieg, Esq.*




If your small business must file for bankruptcy, is Chapter 11 your best option? The answer depends on the type of debts your company has and what you want to achieve by filing for bankruptcy. For purposes of this article, "small business" refers to a closely held enterprise with one person or a family in control (which differs from the Bankruptcy Code's definition of "small business debtor").

**How do Chapter 7 and Chapter 11 bankruptcies differ?**

Some small businesses choose to file for bankruptcy under "Chapter 7," or "straight" bankruptcy. In Chapter 7, a company places all of its assets and debts in the hands of an administrator called a trustee. The trustee tries to liquidate the assets so creditors can be paid. This almost always means that the business does not remain in operation.

In a Chapter 11, the company usually operates and avoids liquidation by providing creditors a share of its future income that at least equals what they would get in Chapter 7. However, before filing a Chapter 11, you should be aware of some pros and cons.

**Chapter 11 Pros:**

■ ***Control and reorganization:*** The primary benefits of Chapter 11 are retaining control, gaining breathing space to reorganize and remaining in operation. The company's existing management usually remains in charge. The business is not handled by a "trustee," but by the debtor, called the "debtor-in-possession."

■ ***Automatic stay:*** Filing for bankruptcy immediately stops almost any creditor collection activity. This includes lawsuits, levies and collection calls. This stay is effective even if creditors do not actually know the filing has occurred.

■ ***Plan provides creditor classes and treatment:*** In Chapter 11, the company usually proposes a plan that defines the classes of creditors and how they will be treated. Creditors vote on the plan, which becomes the central document in the case. Chapter 11 plan options are almost limitless.

■ ***Exclusivity:*** Initially, only the company can file a plan. This gives the company important bargaining leverage with creditors.

■ ***Plan binding on all creditors:*** Even if all creditors vote for the

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## Valuing Closely Held Businesses

*By Michael J. Stevenson and Courtney Sparks White*

The value of a closely-held business is often a key piece of information to be considered on many different occasions, such as when drafting an estate plan, negotiating a divorce, handling a shareholder dispute, making an exit/succession plan or when dealing with other life-changing events. Owning an interest in a closely held business differs from owning an interest in a publicly traded company. The owner of a closely held business does not have the luxury of quickly looking up the stock price to see what the company is worth. Therefore, calling on the expertise of a skilled valuation professional can help a closely held business owner make better decisions.

Key to valuing a closely held business is the ability to analyze the specific company's information in light of the economy, industry and current finan-

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**Chapter 11,** cont. from page 1

plan, the bankruptcy court must still approve it. However, if the court confirms the plan it will be binding on all creditors whether or not they voted on the plan and even if they voted against it.

**Chapter 11 Cons:**

■ ***Cost and creditor committee:*** The company must pay all legal and professional fees in full when the plan is confirmed unless the professionals agree otherwise. If a creditor's committee is appointed, the company must also pay its legal and professional fees upon confirmation. This can create a cash crunch for the debtor.

■ ***Existing owners may lose company ownership:*** The Bankruptcy Code and state law say creditors must be paid in full before existing owners receive any payment or property from the business. This "absolute priority rule" means that, if creditors object, existing owners cannot continue to own the company, because they received property (in the form of retaining their ownership) while creditors were not fully paid.

A business can avoid this loss of ownership if the existing owners can contribute additional cash to the company or by paying all creditors in full over time, (e.g., five years or more).

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**Closely Held,** cont. from page 1

cial environment. This analysis gives the closely held business owner a valuable tool to formulate an estate plan, to navigate a divorce, to resolve a shareholder dispute or to craft a practical succession plan.

There are three main approaches to valuing a closely held business:

**Key to valuing a closely held business is the ability to analyze the specific company's information in light of the economy, industry and current financial environment.**

1) The market-based approach is similar to valuing real estate. This approach relies on transactions of similar companies or entities and applies the data to the closely held business to be valued. It is most helpful when comparable transactions are available.

2) The income-based approach relies on the particular company's earnings. This approach looks at the sustainable or projected earnings of a company and assesses an appropriate amount of risk for those earnings. Cash (flow) is king when analyzing value under this method.

3) The asset-based approach focuses on the business's balance sheet. Specifically, each item on the balance sheet (tangible assets, intangible assets and liabilities) is adjusted. This approach is most advantageous for valuing holding companies or for valuing companies to be liquidated.

How do valuation experts determine which method to use? It depends on the purpose, the facts and circumstances of each business, general market conditions and other factors. Let's say a widget business wants to exit the market through sale to a third party. This business's value may be determined based on a combination of approaches. For example, both an income-based approach focused on earnings *and* a market-based approach may be appropriate if many similar widget businesses have sold in the past.

Understanding the purpose and the various approaches are fundamental to valuation. Applying valuation theory to the nuances of each business produces the most effective result and provides more "value" to the closely held business owner than just coming up with a price. As Warren Buffett says, "Price is what you pay; value is what you get."

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## Time-Saving Option Helps Small Businesses under Audit

The Fast Track Settlement (FTS) program can help small businesses and self-employed individuals who are under examination by the Small Business/Self Employed (SB/SE) Division of the IRS. Modeled on a similar program long available to large and mid-size businesses, FTS uses alternative dispute resolution techniques to help taxpayers save time and avoid a formal administrative appeal or lengthy litigation. As a result, audit issues can usually be resolved within 60 days, rather than months or years. Plus, taxpayers choosing this option lose none of their rights because they still have the right to appeal even if the FTS process is unsuccessful.

For more information on the Fast Track Settlement program, visit the Alternative Dispute Resolution webpage at IRS.gov.

*Information provided by the Internal Revenue Service.*