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My View: Is Chapter 11 bankruptcy a sword or a shield?

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Bankruptcy has and continues to be newsworthy, but it bleeds into the daily lives of business owners and entrepreneurs when it has a political or personal component to it.

The recent presidential debates drew significant attention to Republican candidate and celebrity developer Donald Trump and several of his investments in companies that sought protection from creditors under the U.S. Bankruptcy Code.

Trump drew criticism from rival GOP hopefuls who sought to use the bankruptcy filings as a reason to disqualify him as a candidate for the White House. If he was unable to successfully manage his companies, they argued, how could he effectively manage the country?

Trump, who fancies himself as a quintessential deal maker, responded that he never personally went bankrupt. It was several businesses in which he had invested that fell on hard times. He was not ruined personally, even though in one instance — the collapse of the Taj Mahal casino in Atlantic City — he had to sell personal assets to pay off loans.

The U.S. Bankruptcy Code governs bankruptcy through sections or chapters designed to help businesses or individuals achieve different goals. Chapter 11 is typically business reorganization. Chapter 7 is a liquidation of either a business or personal estate. Chapter 13 is used by people who have a regular income and the means to repay some debt, and can do so on a scheduled basis.

One could argue that the Trump casinos sought refuge in court for reasons beyond management's control: a tough economy or a saturated casino marketplace in Atlantic City.

Whatever the reason, Trump used Chapter 11 as many other troubled businesses have used it: as a tool to reorganize a business with more complicated assets, liabilities and contractual relationships. The goal was to provide a respite or some breathing room from financial problems to retool or fix business issues by offloading burdensome contracts, business units, and liabilities while formulating a plan for the business to continue on as a viable business. The goal is to preserve value for stakeholders, including creditors, employees, relationships with suppliers and customers and sometimes shareholders. Many years ago, Chapter 11's were actually used to provide time for a business to fix financial and operational problems and to make appropriate changes to become a more productive, efficient and profitable business.

Bankruptcy As a Shield

At its core, Chapter 11 was intended to provide a mechanism for our capitalist economy to assist businesses that are underperforming, but are not completely broken.

The shield from creditors provides a tool to fix operational issues, offload bad contracts, and jettison failed divisions or projects, while providing breathing room from creditors who are demanding repayment.

The old adage that "time is money" could not be truer in Chapter 11 as sometimes the parties all have lawyers, investment bankers and financial advisors who generally seek payment from the same pot of funds that are also earmarked to pay creditor claims. This situation has moved Chapter 11 into the realm of "quicker is better." The costs of Chapter 11 along with the lenders' desire to quickly move on from a business problem or failure has created an environment to quickly sell assets in bankruptcy.

Section 363 of the Bankruptcy Code governs asset sales. This "363 sale process" is currently considered to be more cost effective, but sometimes only provides a simple balance sheet fix, meaning debt is moved down the capital structure to equity and prior equity is wiped out or diluted. Fixing the business, the reason for the shield, is often left to the next guy who buys, controls or operates the business.

An example of a successful use of bankruptcy as a shield is HearUSA Inc., a South Florida public company that at the time owned and operated hearing aid centers in 10 states. HearUSA was in complex litigation with its lender and facing a foreclosure action. The company filed a Chapter 11, held a successful sale process that yielded payment in full to all creditors and provided a return to equity.

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Bankruptcy As a Sword

There have been instances where debtors use Chapter 11 to aggressively strip out debts, leases, employee benefit plans and union contracts. One of the most famous instances of this was the Eastern Airlines bankruptcy, where all of the parties hacked each other to death and value was lost by all parties.

Although Chapter 11 laws are tweaked from time to time, they are the law of the land and ingrained into our economic system. Chapter 11 can be used by capitalists or crooks as either a shield to fix business problems or as a sword to aggressively make business changes.

Regardless of the outcome, bankruptcy is an effective tool to fix a business' financial problems when a balance can be achieved between the sword and the shield.

In Trump's case, while his creditors had to take a financial haircut, he did, too. And that is the essence of a balanced outcome.

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