Chapter 26
Bankruptcy, Workouts, and Corporate Reorganization

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**26.1 Introduction**

Macy’s. Bradlees. Caldor. Penn Square. Eastern Airlines. Chrysler (almost, in the 1970s). Bankruptcy claims many firms, large and small, each year. Although the immediate reason why a firm may file for bankruptcy protection is financial, that is usually the symptom rather than the cause, which may include poor management, bad marketing, excess costs, outdated products, and so on. Some firms are able to work out their problems, restructure their finances, and remain a going concern. Others whose root problems run too deep or who are in too big of a financial hole end up selling their assets and disappearing from the business pages. In this chapter, we’ll learn about the process, the problems, and the issues that are involved in bankruptcy and corporate reorganizations.

Ideally, the management, shareholders, employees, and other stakeholders in a firm, given the choice, would like to see the firm stay in existence as a profitable entity. However, firms do fail for a variety of macro- and microeconomic reasons. Regardless of the reason for failure, all of the stakeholders are losers. The main objective of this chapter is to present an overview of the bankruptcy procedure. We begin with a look at what constitutes financial distress and failure. The terms *insolvency* and *illiquidity* are defined and are shown to lead to bankruptcy. The legal forms of bankruptcy then are discussed.

Bankruptcy and reorganization are very technical legal process governed by federal and state laws. Therefore, legal advice is mandatory during these processes.

**26.2 What is Financial Distress and Failure?**
**Financial distress** means that a firm’s short-run operating and financial cash inflows are less than its outflows. This may be good or bad. Table 26.1 shows the quarterly sources and uses of funds for two firms, Firm A and Firm B.

As can be seen in Table 26.1, neither firm is currently failing; each has a positive net income of $10. Yet we might wonder if Firm A is facing financial distress because it is selling assets and not making any investments for future operations. Firm B, although paying only half as much in dividends as Firm A, appears to be in better financial shape. It has the ability to raise capital in the debt market and it is investing for future growth and profitability.

If Firm A were to continue to operate in this fashion, eventually the financial distress would lead to insolvency and/or failure. **Insolvency** means that the firm does not have sufficient cash inflows to meet all of its cash outflows. If Firm A continues to sell assets left to sell and no operating plant and equipment to produce a product. At this point, it is bankrupt, out of business. Prior to going bankrupt, Firm A will have become insolvent, without cash inflows from operations to meet legally binding outflows. On the other hand, because of its investments (indicated by the line “Buy assets” in Table 26.1), Firm B will have the capacity in the future to manufacture a product to generate operating cash flows that can be used to meet its obligations.

**TABLE 26.1 Quarterly Sources and Uses of Funds**

Firm A

|  |  |
| --- | --- |
| *Sources* | *Uses* |
| Net income | $10 | Loss | $0 |
| Depreciation | 5 | Dividends | 22 |
| Sell assets | 5 | Buy assets | 0 |
| Borrow | 1 | Pay off debt | 0 |
| Issue stock | 1 | Repurchase stock | 0 |
| Total sources | $22 | Total uses | $22 |

Firm B

|  |  |
| --- | --- |
| *Sources* | *Uses* |
| Net income | $10 | Loss | $0 |
| Depreciation | 5 | Dividends | 11 |
| Sell assets | 0 | Buy assets | 11 |
| Borrow | 6 | Pay off debt | 0 |
| Issue stock | 1 | Repurchase stock | 0 |
| Total sources | $22 | Total uses | $22 |

**Financial failure** has much more to do with the legal concept of bankruptcy than does financial distress. Financial failure means that the firm’s assets are smaller than its liabilities. The firm has a negative net worth. A negative net worth implies that the firm cannot meet its legal obligations, so it is bankrupt. These definitions raise two important and related issues: illiquidity and insolvency. One is a cash flow concept, and the other is a legal term related to the balance sheet.

**A. Illiquidity**
The term **liquidity** can be defined as the ease with which assets can be converted into cash at a fair price in a reasonable amount of time. **Illiquidity** is the opposite of liquidity. Either an asset cannot be converted into cash (e.g., a leased machine cannot be sold for $1 million, but the best offer from another buyer is $100,000). In the latter case, if the firm keeps the asset and uses it, it is worth ten times more than the amount of cash it could raise in a sale in the market.

Liquidity is the most important factor that the financial manager must deal with on a day-to-day basis. By supplement cash inflows from investment with financing inflows, the financial manager ensures the survival of the firm.

In the short run, many firms may be illiquid, that is, they may lack cash. They remedy this situation by short-term borrowing. A firm borrows cash to meet its current obligations, knowing that is cash flow will improve in the future. This kind of illiquidity is transitory and is not associated with insolvency or bankruptcy. On the other hand, if a firm faces illiquidity with no expectation of future cash flow improvement, illiquidity may lead to insolvency and bankruptcy.

**B. Insolvency**
Although all businesses expect to succeed, many do not. Various financial indications of serious difficulty often are apparent. Cash shortages may cause illiquidity, borrowing may increase, accounts may be overdrawn, and maintenance of plant and equipment may be delayed. Careful observation of either profit or cash receipt and disbursement trends may signal pending financial troubles. However, frequently occurring illiquidity can make the difficulty so acute that the problem can no longer be ignored.

**Kinds of Insolvency.** Cash flow problems can create either technical or legal insolvency. *Technical insolvency* is the inability of the firm to meet c ash payments on contractual obligations. The lack of cash to meet accounts payable, wages, taxes, interest, and debt retirement will constitute technical insolvency, even if the enterprise has adequate assets and generates both economic and accounting profits.

When assets are plentiful in relation to liabilities, a financial manager usually can plan ahead and arrange for sufficient cash through various sources to prevent any embarrassment. Most liquidity problems can be overcome by borrowing or through the planned liquidation of certain assets. A sound, profitable business should have no difficulty in this regard, and reasonably intelligent planning should ward off the danger of technical insolvency. However, if the firm is technically insolvent because of successive losses, poor management, or insufficient investment in working capital, then lenders will be less willing to place funds at its disposal.

 The financial manager also should be aware of the potential for variability in the availability of funds. Even a willing lender often is hesitant during periods of tight money, great financial uncertainty, or panic.

*Legal insolvency* is a more serious financial problem than technical insolvency. Legal insolvency exists when a firm’s recorded assets amount to less than its recorded liabilities. This condition arises when successive losses create a deficit in the owners’ equity account, rendering it incapable of supporting the firm’s legal liabilities. The firm may be legally insolvent even when it is liquid and has plenty of cash to pay its current bills. Outsiders may not be aware of the insolvency as long as the liquidity of the firm enables it to meet its cash obligations. A protracted period of legal insolvency usually leads to bankruptcy.

Violation of a bond indenture agreement also may prove a source of financial insolvency for a firm. A bond indenture is the contract between the firm and its bondholders. A third-party trustee acts to represent the collective interests of the bondholders to monitor compliance with the indenture. Besides giving bondholders a contractual claim to interest payments, the indenture may require the firm to may annual payments to a sinking fund along with certain other provisions designed to protect the security of the bondholders.

If a firm fails to make a sinking fund payment, or to meet any other obligation under the indenture, the trustee is responsible for undertaking appropriate action. Pressure by the trustee on the firm usually will do little to alleviate a problem already in the advanced stage. However, the trustee can warn bondholders of the difficulties and help to form a bondholders’ committee to be activated in the event of in-court or out-of-court adjustments.

Usually by the time a creditors’ committee has been formed, the hope of getting all—or even any—of the creditors’ money back is quite small.

EXAMPLE 26.1
Q: Consider two identical firms, Firm A and Firm B; both are having liquidity problems. The balance sheets of both firms are the same and are shown in the table below. If the long-term debt of Firm A has no restrictions, and the indenture of the long-term debt of Firm B requires net working capital to be greater than zero, are the firms illiquid? Insolvent?

**Financial Statement of Firms A and B
Firm A, Firm B
Balance Sheet
31 December 1996**

Cash $100 Accounts payable $1,250
Accounts receivable 1,000 Bank loan $1,250
Inventory 1,000 Long-term debt 7,500
Fixed plant and equipment 10,000 Equity 2,100
Total assets $12,100 Total liabilities and equity $12,100

A: If we look at the net working capital of both firms, we see it is negative. Current assets ($2,100) minus current liabilities ($2,500) equals -$400. Depending on the cash flow from accounts receivable and the payment dates of accounts payable and the bank loan, both firms are facing illiquidity problems. The long-term debt of Firm A has no restrictions, whereas the indenture of the long-term debt of Firm B requires that working capital be greater than zero. In this case, both firms are illiquid, but Firm B also is insolvent.

**Responses to Insolvency.** A firm that finds itself in financial distress due to one of the above states of insolvency or failure to satisfy a bond indenture has several alternatives:
1. Do nothing, but hope something will come along to save the situation.
2. Attempt to sell out. The firm can try to find a buyer, but buyers of troubled firms may be few. Even if one can be found, the seller frequently feels fortunate to walk away with any portion of the original equity.
3. Seek adjustments with creditors outside of the judicial process, commonly called a workout. Some arrangements between the firm and its creditors may permit it to keep operating with the hope that it can work its way out of trouble. Such adjustments usually take the form of extensions of repayment schedules and/or compositions of credit, as described in the section below.
4. Seek court relief in bankruptcy proceedings in the form of a reorganization or liquidation.
5. Assign assets to a third party for liquidation.
6. Liquidate.

FROM THE BOARDROOM: When to Hold, When to Fold
 More and more, senior executives are being pressured to maximize the economic value of their operating units and to look for ways to create more value for shareholders. The marketplace is making clear it won’t tolerate underperforming units, requiring each business unit to earn a satisfactory return given the resources invested in it and its interrelationships with the other business units of the parent entity. If the unit doesn’t, the economic value of the entire company will feel the impact.

 That’s why managements are now focusing on improving the viability of their individual business units—and they’re looking for tools to help them. There are common factors you must measure and assess, and these are incorporated into a five-step process for addressing the viability of business units and the viability of the overall business entity. Here are the five steps:

* *Understand the characteristics of the industry in which your business unit resides.* This isn’t a simple task. Industries change, and these changes may be either smooth and continuous or discontinuous and radical. History is full of cases of firms that failed to recognize the importance of industry developments taking place around them. That’s why you must understand the trends and cycles in your industry. These may relate to sales, costs, profits or other factors.

Remember, the industry may be affected by technology, too, such as point-of-sale systems and electronic data interchange. One of the truly discontinuous factors affecting business is the regulatory sector.

* *Next, critically analyze and challenge your business unit’s position within its market.* If the industry offers a real opportunity for success, positioning is paramount. But, even in struggling industries, the business unit’s position is important.

Positioning includes every aspect by which your business unit might be compared to its competitors: its mission and all of its strategies, its plans, its tactics and its resources.

* *Thoroughly dissect the economic model of how your business unit generates profits.* To maintain its competitive position, a business unit must be profitable enough to pay its operating expense, fund any necessary investments, service its debt and reward capital.
* *Evaluate the business unit’s capital structure.* A capital structure that allows the business unit to sustain downturns, withstand competitive threats and capitalize on opportunities is critical to the unit’s viability.

The design of the capital structure must be appropriate for the industry and accommodate company-unique factors. For example, industries and companies with strong, relatively certain cash flows can employ more low-cost debt in their capital structure than can firms facing dramatic cycles and volatile cash flows. The structure should meet your business unit’s working and permanent capital needs at a competitive cost of capital and, just as important, the composition of the invested capital should give you flexibility and a cushion based on the industry’s cyclicality and the unit’s ability to earn the required rate of return on the various types of capital.

* *Finally, and most important, assess the business unit’s management and the related management processes.* Management is the heart of viability. All of the other factors are linked to and often attributable to management. For a business unit to remain viable, the management team must have the vision to anticipate changes and to conceive the business model needed for the unit to compete successfully.

In short, a company can take one of two paths. Senior management can ignore its business unit’s positioning, as it barrels down the road without seeing such warning flags as changing industry conditions, a declining competitive position, declining profitability, an inadequate capital structure or an ineffective management process. Or you can work in tandem with the business unit’s management to assess the current position of the unit and determine where it needs to go. Together, you can develop a mission statement, along with a strategic plan, an operating plan, appropriate action programs and the necessary financial forecasts and risk analyses.

 *Source:* S. F. Cooper, M. E. France, L. J. Lobiondo, and N. A. Lavin, “When to Hold, When to Fold,” Excerpted with permission from *Financial Executive,* Novemeber/December 1994, pp.40-44, copy right 1991 by Financial Executives Institute, 10 Madison Avenue, P.O. Box 1938, Morristown, NJ 07962-1938 (201) 898-4600.

**26.3 Voluntary Restructuring and Corporate Focus**
Firms sell assets to other firms—a process referred to as restructuring—for three reasons. First, the asset is worth more to the buyer than the seller. Second, the divested asset interferes with the seller’s operations. Third, the buyer is willing to overpay for the asset.

Selling unrelated assets leads to a more efficient operation of the firm’s remaining core businesses. The motives for selling the asset include the elimination of negative synergies with the divested assets and/or increased efficiency arising from better allocation of management time and other resources. Once a firm has sold the unrelated assets, whether the decision is the correct one or not depends upon how well management focuses on the remaining assets. Improved corporate performance occurs only if the business’ focus is more sharply defined on the remaining assets.

During the decade of the 1980s in the U.S., we saw a massive “downsizing” of U.S. industry. This is offered as one explanation of the relatively good performance of the U.S. economy during the decade of the 1990s.

Today, management has three basic approached to voluntary restructuring. *Carve outs* occur when the parent sells a partial interest in a subsidiary through an IPO. The carve out may increase the selling firm’s value due to benefits from restructuring the asset composition of the firm. Again, value is enhanced if the manager focuses more on the remaining assets. *Spin-offs* occur when the parent transfers complete ownership of a subsidiary to the existing shareholders. The spin-off allows the shareholders to retain control over a given asset base while allowing management to focus on a smaller segment of the firm’s assets. Finally, *sell offs* involve the direct sale of assets to a third party. The selling firm receives cash, which can be used for debt repayment or reinvestment in the remaining assets. Management in this case cannot only refocus on the main line of core business but also now has the wherewithal to finance any necessary changes.

Any of these voluntary approaches may be used by managers of troubled firms in order to fend off the legal complications stemming from bankruptcy.

**26.4 Bankruptcy**Most corporations that fail do so because of inappropriate management oversight, although firms also fail for a wide range of other reasons, as shown in Table 26.2. When corporations fail either due to repeated illiquidity or bad management, the firm must go through the legal process of **bankruptcy**. The first “Capital Ideas” box in this chapter discusses how bankruptcy differs in a few countries.

Bankruptcy includes a range of court procedures in the United States that may result in the firm being liquidated or financially reorganized to continue operations. This may occur voluntarily if the firm permits a petition for bankruptcy, or a creditor’s petition may force the firm into the courts. Such a petition by a creditor charges the firm with committing one of the following **acts of bankruptcy**: (1) committing fraud while legally insolvent, (2) making preferential disposition of firm assets while legally insolvent, (3) assigning assets to a third party for voluntary liquidation while insolvent, (4) failing to remove a lien on the firm within 30 days while insolvent, (5) appointment of a receiver or trustee while insolvent, or (6) written admission of insolvency.

**TABLE 26.2 Reasons for Corporate Failure**
1. An imbalance of skills within the top echelon. A manager tends to attract other managers of similar skills. For example, corporation management may consist principally of individuals with sales backgrounds who lack production experience.
2. A chief executive who dominates a firm’s operations without regard for the advice of peers.
3. An inactive or ill-informed board of directors. For instance, the board of directors for Penn Central, even including the members who were bankers, supposedly did not become aware of the firm’s impending financial disaster until a few weeks before its declaration of insolvency.[[1]](#footnote-2)
4. A deficient finance function within the firm’s management. Not infrequently, the only substantial input provided by the financial officer occurs when the budget is submitted back to the board. A company may have an effective financial information system; however, this information is of no avail if it does not flow to the board through a strong financial officer.
5. An absence of responsibility for the chief executive officer. Although all other managers within a company are responsible to a superior, the chief executive seldom must account for the increased separation of management and stockholders, this link may be tenuous or even lacking altogether.
6. Extremely variable sales for a capital-intensive product.

**A. Agency Problems**
A company’s shareholders and its creditors usually get along. As long as the firm is profitable, shareholders receive dividends and creditors get their interest payments. If a firm becomes insolvent, the interests of shareholders and creditors quickly diverge. Creditors care nothing about the firm’s ongoing business, as long as they get their money; to assure this, they are willing to sell the assets of the firm. Shareholders are desperate to keep the firm going for as long as possible in hopes that the firm can be turned around and made profitable, thereby saving their investment.

Many legal systems around the world don’t try to resolve these divergent viewpoints; most try to protect one side or the other. A law that backs the creditors might make the liquidation of the firm easy, allowing a good firm to be destroyed before it has a chance to work through bad times. On the other hand, when the law backs the equityholders by making liquidation difficult, it may penalize the creditors by depriving them of their legal right to payments of interest and principal. This, in turn, will make creditors less willing to lend and will raise the cost of borrowing. The second “Capital Ideas” box in this chapter presents an example of the problems faced by both stockholders and creditors when a business has financial difficulties.

U.S. law tries to give equal weight to the concerns of creditors and shareholders. Its various chapters govern difficult bankruptcy situations. When a firm files under Chapter 11 of the U.S. Bankruptcy Code, any reorganization plan must be approved by both creditors and shareholders.

**B. Chapter 11**
**Chapter 11** of the Federal Bankruptcy Reform Act of 1978 tries to allow for a planned restructuring of the corporation while providing for payments to the creditors. Chapter 11 proceedings begin when a petition is filed by the corporation or by three or more creditors. A federal judge either approves or disapproves the petition for protection under Chapter 11. During the petition period, the judge protects the managers and shareholders from creditors and tries to negotiate a rescue plan between the shareholders and creditors. During this time, the corporation continues to do business.

Once in Chapter 11, the firm’s management has 120 days to submit a reorganization plan, which usually includes debt rescheduling and the transfer of equity rights. Anyone has the right to submit a plan, but only very rarely does anyone but management submit a reorganization plan. The plan must secure the agreement of two-thirds of the shareholders and two-thirds of each *class* of creditors; for example, senior creditors whose debt is secured and junior creditors whose debt is unsecured are considered separate classes.

**Reorganization.** Current law allows the bankrupt firm to be reorganized under Chapter 11. The general objective of reorganization is to keep the firm alive while settling creditor’s claims and attracting new capital into the firm.

***CAPITAL IDEAS: French Shareholders vs. British Creditors***
 Countries treat their bankrupt firms differently. Some give priority to keeping the company alive, which favors equity more than debt, or, in some cases, favors employees over both sources of finance. Others encourage paying off creditors. And there are also differences in the role given to formal legal rules and informal deals.
 Equity and employees come first in Japan, where informal rescues, rather than legal bankruptcy procedures, are the norm. Typically, a bank or trading partner with shares in the troubled firm will try to save it. This can mean a big commitment of capital and management, often over several years. And if one big shareholder cannot put the firm right, others often will have a go. However, when the courts become involved, creditors can get a good deal. There are three legal options: *bankruptcy law*, the most widely used, liquidates the firm, sells its assets, and repays creditors. Both *composition law* and company *rearrangement law* allow firms to be restructured, but are seldom used.
 In Germany, too, the emphasis is on preserving equity by keeping the company alive and staying out of the courts, which favors the creditors. A company in trouble usually will be coaxed back to health by its supervisory board or its bankers. If they fail, a German firm must start a bankruptcy action if it sees no chance of paying its bills, or if its liabilities exceed its assets.
 Creditors in Germany have two legal options. One is liquidation, which is clear and brutal. The other is to keep the firm going by rescheduling debt. A court-appointed official decides if the firm can be saved in a way that meets at least 35% of creditors’ claims. In any event, creditors can veto any plan drawn up by the court and firm. Shareholders play no part in the process, but many are also creditors: banks often own shares in the firms they lend to.
 Bankruptcy law is hardest on creditors in France. Proceedings can be started by the firm—which must declare bankruptcy within two weeks of stopping payments to creditors; by a commercial court; by creditors; or, during criminal investigations, by a state prosecutor.
 The firm then goes into *redressment judiciaire*. A court-appointed official helps mangers—who usually keep their jobs—to draw up a plan. This generally takes a few weeks, but can go on for up to 18 months. The plan takes one of three forms: continuation, possibly after debt-rescheduling, which involves raising new capital and selling some assets; the sale of the firm; or liquidation. The law, introduced in 1985, aimed to save jobs by keeping troubled firms alive; even so, some 90% of firms end up being liquidated.
 Creditors have no say over which plan the court decides to accept, and, although different creditors often have conflicting aims, they have just one representative, appointed by the court, during the negotiation. A recent report by the French Bankers’ Association and French Employers’ Confederation concluded that the system sacrifices the interest of creditors in the illusory hope that firms can be saved.
 In Britain, by contrast, the law put creditors’ interest first. Under the 1986 Insolvency Act. Insolvent companies have four formal options (as well as the informal one of a “voluntary arrangement” with the creditor):

* Going into “administration” may keep the company as a going concern. The courts appoint an administrator—typically an accountant or lawyer—to run the business in whatever way maximizes its value. This includes firing its managers, selling bits and winding it up. Administration is used mostly by big firms.
* Under “administrative receivership” secured creditors appoint a “receiver” to run the company. This person is much like an administrator, except that his main task is to raise enough finance to repay secured loans. Keeping the company alive is not the main priority, although if a firm can be rescued, it should be.
* Companies can be wound up by “voluntary liquidation” when shareholders appoint a liquidator to sell assets and pay off creditors.
* Firms also can be wound up by “involuntary liquidation.” In which the liquidator takes over after winding-up request in court by a creditor. Most insolvencies end in liquidation.

***CAPITAL IDEAS: Throwing Money Down a Hole?***
A tunnel under the English Channel, envisioned long ago by Napoleon, has become a reality. The “Chunnel” or “Eurotunnel,” as it is called, cost ₤10.5 billion to build and was one year late and ₤5.8 billion over budget. Eurotunnel, the Anglo-French consortium that built and now operates the tunnel, had to unexpectedly raise additional funds as Chunnel construction took longer than expected and as cost rose. By the time the tunnel opened in May 1994, the financial markets had lost confidence. Eurotunnel’s debt was selling at a discount, 72-74 percent of par; its share price, which had been as high as ₤11 several years previous, was at ₤5 a share. The first shareholder dividend, originally forecast for 1995, is now forecast for after the turn of the century. When the tunnel opened in May 1994, analysts were forecasting that Eurotunnel would run out of cash by June 1995.
 As it turns out, Eurotunnel didn’t run out of cash until September 1995, when it suspended interest payments on its nearly ₤8 billion ($12.4 billion) of bank debt, which it owes to a consortium of 225 banks. Actual revenues and cash flows are down from forecasts due to delays in reaching full operating capacity and a bruising price war with the competition: ferries that take passengers across the channel. As of September 1995, Eurotunnel’s share price was down to ₤1.43. Its interest payments accumulate by about ₤2 million a day, while its revenues are only about ₤660,000 a day. Analysts’ expect that to salvage the financially troubled Chunnel, banks will have to agree to trade some of their debt for equity. One forecasts states that the Chunnel needs to convert ₤3 billion of its debt to equity, further diluting troubled shareholders’ holdings.

**EXAMPLE 26.2**

**Reorganization**

**Q:** A firm that is undergoing reorganization under Chapter 11 has the balance sheet shown in Table A below. The firm’s creditors are in agreement that the present value of the firm’s earnings will exceed the liquidation value of the firm and the firm’s cash flow can support a debt structure of $50 million. The short-term creditors agree to a 50-percent settlement, as shown in Table B.

Table A

Balance Sheet for Firm Prior to Reorganization

**A Firm
Balance Sheet
1 July 1996 (Before reorganization)**

|  |  |  |
| --- | --- | --- |
| **Assets** | **Liabilities and Equity** |  |
|  | Accounts Payable | $6 |
|  | Notes payable | 16 |
|  | First mortgage | 28 |
|  | Debentures | 50 |
|  | Total debts | $100m |
|  | Equity |  |
|  | Common stock | 10 |
|  | Retained earnings | (60) |
|  | Total liabilities and equity | $50m |
| Total assets $50m |  |  |

**Table B
Reorganization Plan**

|  |  |  |
| --- | --- | --- |
| **Creditors** | **Amount of Claim** | **Claim After Reorganization** |
| Account payable | $6 | $3 (50%) |
| Notes payable | 16 | 8 (50%) |
| First mortgage bond | 28 | 28 (fully converted) |
| Debentures | 50 | 11 ( residual) |
| Total debt |  | $50 m |

Within the required 120 days, the firm’s management has submitted the reorganization plans shown in Table B, along with the plan for issuing new securities shown in Table C.

**Table C
New Securities for Reorganization Plan**

|  |  |  |
| --- | --- | --- |
| **Old Security** | **New Security** | **Amount** |
| Accounts payable | Accounts payable | $1.5m |
|  | Common stock | 1.5m |
| Notes payable | Preferred stock | 4.0m |
|  | Common stock | 4.0m |
| First mortgage bond | First mortgage bonds | 14.0m |
|  | Debentures | 14.0m |
| Debentures | Common stock | 11.0m |
| New total capital |  | $50.m |

The creditors and shareholders approve the plan and the bankruptcy court confirms it. After the reorganization, what is the firm’s capital structure?

**A:** Using the information in Table C, we obtain:

**Table D
Capital Structure After Reorganization
A Firm
Balance Sheet
15 October 1996 (After reorganization)**

|  |  |  |
| --- | --- | --- |
| **Assets** | **Liabilities and Equity** |  |
|  | Accounts payable | $1.5m |
|  | First mortgage bonds | 14 |
|  | Debentures | 14 |
|  | Preferred stock | 4 |
|  | Equity |  |
|  | Common stock | 16.5 |
|  | Total liabilities and equity | $50m |
| Total assets $50m |  |  |

**Reforming Chapter 11.** Some critics argue that Chapter 11 is flawed and needs reform because it favors shareholders over creditors and junior creditors over senior creditors. They claim it is unfair that shareholders and junior creditors can vote to approve the reorganization plan as equals with the senior creditors.

Also, time works against creditors in Chapter 11. Upon approval of a reorganization plan by the court, interest payments to creditors stop and legal fees begin to erode the remaining value of the firm. Often senior creditors settle for less than their full debts simply to save time. Shareholders, on the other hand, wish to draw out the reorganization period as long as possible hoping for a turnaround; they have little or nothing left to lose.

In general, this delay is bad for the company. IF a firm’s managers know they can default on debts and still keep their jobs, they may tend to abuse creditors. This could cause shareholders to require larger returns on their capital and creditors to be less willing to risk their funds.

Critics have presented two basic ideas for reforming Chapter 11: (1) increase the bureaucracy, and (2) allow the market to decide. The first proposes setting time deadlines after which independent arbitrators (more bureaucracy) decide a firm’s fate. This would put bankruptcy more firmly in the hands of bureaucrats. The second reform proposal involves creating opportunities for creditors and owners to sell their positions to each other or third parties at prices determined competitively in the market. This market-based solution would encourage whoever ends up with equity control to make the firm as valuable as possible.

**C. Liquidation**
Bankruptcy law favors reorganization through Chapter 11, but if the firm cannot be preserved as a going concern, the law requires **liquidation**. Liquidation involves selling the firm’s assets and distributing the proceeds to the creditors in order of the priority of their claims. **Chapter 7** of the Bankruptcy Reform Act of 1978 covers liquidation of a firm.

In determining whether or not to liquidate a firm, the law asks: Is the firm worth more dead than alive? In other words, is the net present value of the liquidated parts of an enterprise greater than the present value of the firm as a going concern? If the answer is *yes*, the firm’s assets are sold and the creditors are paid off. If the answer is *no*, then Chapter 11 proceedings usually are followed.

Once the liquidation of assets has begun, it usually becomes painfully clear that few, if any, assets except cash bring their balance sheet values. Indeed, a significant reduction in asset values is to be expected. Because of this, not all claims on these assets will be satisfied in full; no liquidation generates enough cash to cover all claims.

In this event, available cash must be allocated to the various claims according to a rule called the *absolute priority of claims*. This rule requires satisfaction of certain claims prior to the satisfaction of other claims. The priority of claims in liquidation or reorganization typically takes the following order;
1. *Special current debt*, which includes trustee expenses, unpaid wages that employees have earned in the 90 days preceding bankruptcy (not to exceed $2,000 for any one case), and contributions to employee benefit plans that have fallen due within the 180 days preceding bankruptcy.
2. *Consumer claims* on deposits not exceeding $900 per claim.
3. *Tax claims*.
4. *Secured creditors’ claims*, such as mortgage bonds and collateral trust bonds, but only to the extent of the liquidating value of the pledged assets.
5. *General creditors’ claims*, including amounts owed to unsatisfied secured creditors and all unsecured creditors, but only to the extent of their proportionate interest in the aggregate claims of their classes.
6. *Preferred stockholders’ claims*, to the extent provided in their contracts, plus unpaid dividends.
7. *Residual claims* of common stockholders.

**EXAMPLE 26.3 Absolute Priority of Claims**

**Q:** To illustrate the application of the absolute priority of claims, Table A shows the balance sheet for Dead Beat, Inc., a bankrupt firm. The book value of the company’s assets is $100 million, but this is substantially larger than the liquidation value of $30 million. What will be the distribution of the funds received from liquidation?

**Table A
Balance Sheet of Bankrupt Firm
Dead Beat, Inc.
Balance Sheet
31 Aug 1996**

|  |  |  |
| --- | --- | --- |
| **Assets** | **Liabilities and Equity** |  |
|  | Accounts payable | $2m |
|  | Accrued wages | 2 |
|  | Accrued taxes | 2 |
|  | Mortgages (secured by fixed assets) | 50 |
|  | Debentures | 30 |
|  | Preferred stock | 20 |
|  | Equity |  |
|  | Common stock | 14 |
|  | Retained earnings | (20) |
| Total Assets $100m | Total liabilities and equity | $100m |

In addition, the accrued wages are all within three months of the bankruptcy and are all less than $2,000 per claim. There are no customer deposits to return. The proceeds from the sale of assets related to the mortgage are $5 million. The costs of administering the bankruptcy are $1 million.

**A:** The asset liquidation value is only $30 million, which is much smaller than the book value of the company’s total assets. Based upon the rule of absolute priority claim, the company should first distribute to the claims of:

|  |  |
| --- | --- |
| Cost of administering bankruptcy | $1m |
| Accrued wages | 2 |
| Accrued taxes | 2 |
| Proceeds from sale of mortgaged building | 5 |
| Total prior claims | $10m |

There are $20 million ($30m - $10m) available to general creditors.

Total claims for general creditors are:

|  |  |  |
| --- | --- | --- |
| Account payable |  | $2m |
| Mortgage | 50 – 5 = | 45 |
| Debenture |  | 30 |
|  |  | $77m |
| Percentage of payment to general creditors is |  | $20m = 25.97% |
|  |  | $77m |

Based upon 25.97%, the distribution of $20 to general creditors are:

|  |  |
| --- | --- |
| Account payable | 2 X 25.97% = $ .52m |
| Mortgage | 45 X 25.97% = 11.69 |
| Debenture | 30 X 25.97% = 7.79 |
|  |  $20m |

There is nothing left for both preferred and common shareholders.

**26.5 Out-of-Court Settlement**
Many financially embarrassed firms avoid bankruptcy by some sort of “workout” arrangement with their creditors. A creditor may not wish to sue for satisfaction of a claim if it seems likely to recover less than the full value of its claim, assuming the firm’s financial difficulties appear temporary. The workout requires the agreement of almost all creditors and the loss of some of all management control by the owners. Small creditors frequently try to hold up workout agreements and thus force major creditors to advance funds to pay off small claims in full or in proportions greater than those received by other creditors. A successful workout may provide major creditors full satisfaction of their claims, while avoiding bankruptcy proceedings and the attendant court costs.

**A. Extensions**
Sometimes creditors will agree to *extensions* of the maturity dates of loans for which the principal payments currently are past due. Although this does not correct a fundamental disorder in a firm’s finances, it does give the firm more breathing room; it allows the firm to make other adjustments in its financial resources without the burden of immediate repayment of the principal of the loan. Creditors don’t give extensions without cost, however. They may impose restrictions on a firm’s dividends; ask major owners of a small firm to put up more money, or preclude future borrowing except through subordinated debt.

**B. Composition**Composition is another way a firm can adjust its capital sources. This method involves recomposing the debt of the firm in such a way that the creditors receive partial payment for their claims, say 60 cents for each dollar. Creditors may find it more expedient to follow this route than to take the troubled firm to court to seek full satisfaction. In court, they would run the risk of receiving less than they would through composition. Moreover, court appearances require various legal costs, which may more than offset the possible gains achieved by going to court.

**C. Creditors’ Committee**
A third method of adjusting a capital structure without bankruptcy proceedings involves the operation of the enterprise by a group of creditors, called a *creditors’ committee*. These representatives manage the firm until it gathers sufficient liquid capital to satisfy existing claims or until an acceptable composition is found.

There is no legal compulsion for any creditor to accept an out-of-court adjustment. Any creditor can delay the process if it is dissatisfied with a proposal by the majority (or minority) of creditors to relieve the financial burden on the firm. The unhappy creditor can refuse the arrangement and insist that a claim be met in full; if it is not, the creditor can take the firm to court to be liquidated or reorganized.

**26.6 Summary**
In this chapter, we have presented an overview of the current state of the U.S. Bankruptcy laws, especially Chapter 11 and Chapter 7 of the Federal Bankruptcy Reform Act of 1978. Debate continues as to whether or not this act is doing its job to strengthen the economy in the long term by providing the legal mechanism needed to liquidate or reorganize inefficient or failing firms. Critics of the current bankruptcy laws argue that:
 1. The firm’s management is entrenched in its position. Most managers stay with the firm through bankruptcy proceedings.
 2. Most companies that go through bankruptcy are liquidated.
 3. There is no incentive for the bankruptcy process to be handled in a timely fashion.

**Self-Test Problems**

**1. The Absolute Priority of Claims Doctrine**
XYZ Corporation has just completed the sale of all of its assets for $1 million. Following the absolute priority of claims doctrine, show how these proceeds should be distributed to the creditors and owners of XYZ Corporation.

**XYZ Corporation
 Liabilities and Equities
 31 December 1996**

Wages payable $300,000
Consumer claims payable 25,000
Taxes payable 100,000
Accounts payable 75,000
**Total current liabilities $500,000**
Mortgage payable 400,000
Debentures 100,000
**Long-term liabilities $500,000**
Common stock 400,000
Paid-in capital 100,000
**Equity $500,000**
***Total liabilities and equity $1,500,000***

**2. The Absolute Priority of Claims Doctrine**
ABC Corporation has just completed the sale of all its assets for $1 million. Following the absolute priority of claims doctrine, show how the proceeds should be distributed to the creditors and owners of ABC Corporation.

**ABC Corporation
 Liabilities and Equities
 31 December 1996**

Wages payable $200,000
Taxes payable 50,000
Accounts payable 100,000
**Current liabilities $350,000**
Mortgage payable 250,000
Debentures 700,000
**Long-term liabilities $950,000**
Common Stock 500,000
Paid-in capital 500,000
**Equity $1,000,000**
***Total liabilities and equity $2,300,000***

**Discussion Questions**
1. Explain in your own words the following terms:
 a. financial distress
 b. illiquidity
 c. insolvency
 d. bankruptcy
2. What is the difference between reorganization and liquidation?
3. What is a creditors’ committee? What type of power does a creditors’ committee have?
4. Identify the major difference between technical insolvency and legal insolvency.
5. According to Table 26.2, what are the major reasons for corporate failure? Do those reasons make sense to you? Can you find examples in *The Wall Street Journal* to illustrate those reasons?
6. Explain the difference between a cash flow view of bankruptcy and an accounting view of bankruptcy.
7. How are the rights of bondholders protected in the event of financial distress?
8. What are the basic arguments given for the need to reform Chapter 11?
9. What are some ways that a bankruptcy can be settled out of court?
10. Briefly explain how a bond indenture agreement can affect the solvency of a firm.
11. What actions can a firm that is in financial distress take to satisfy a bond indenture?
12. Provide some of the reasons for corporate failure.
13. What is composition?
14. If a firm is liquidated, what claim do stockholders have on the assets of the firm?
15. What effect does the conflict between stockholders and bondholders have on the probability of bankruptcy?
16. Should bankruptcy law favor creditors over owners, managers, or employees?
17. What problems might arise between stockholders and bondholders in a firm that is experiencing financial distress?

**Problems**
1. **The Absolute Priority of Claims Doctrine**
The DEFG Corporation has just completed the disposal of all of its assets for $2 million. Following the absolute priority of claims doctrine, show how the proceeds should be distributed to the creditors and shareholders.

**DEFG Corporation
 Liabilities and Equities
 31 December 1996**

Liquidation expenses payable $25,000
Wages payable 300,000
Taxes payable 75,000
Accounts payable 600,000
**Current liabilities $1,000,000**
Long-term bonds 1,000,000
Subordinate debentures 1,000,000
**Long-term liabilities $2,000,000**Equity
Common Stock 1,000,000
**Liabilities and equity $4,000,000**

2. **The Absolute Priority of Claims Doctrine**
CDE Corporation has just completed the disposal of all of its assets for $1.5 million. Of this amount, $500,000 was realized from the sale of a building that had a $1 million mortgage against it. Following the absolute priority of claims doctrine, show how the proceeds should be distributed to creditors and shareholders.

**CDE Corporation
 Liabilities and Equities
 31 December 1996**

Wages payable $300,000
Taxes payable 300,000
Accounts payable 400,000
**Current liabilities $1,000,000**
Mortgage payable 1,000,000
Long-term bonds 1,000,000
**Long-term liabilities $2,000,000**Equity
Common Stock 1,000,000
**Liabilities and equity $4,000,000**

3. **Balance Sheet for a Reorganization Plan**The capital structure of No Go is:

Accounts payable $2m
Notes payable 4m
First mortgage bonds 8m
Debenture 16m
Preferred stock 10m
Equity
Common Stock 10m
Retained earnings (30m)
**Total liabilities and equity $20m**

The firm’s assets are valued at $20 million. The first mortgage bonds are fully covered. The short-term creditors have agreed to share the loss at 50 percent. The debenture-holders will be residual and the preferred-holders will get nothing. Develop a reorganization plan for No Go. What is No Go’s balance sheet if your plan is accepted?

1. R.F. Murray, “The Penn Central Debacle: Lessons for Financial Analysis,” *Journal of Finance*, Vol. 26, No. 2, May 1971, pp. 327-332. [↑](#footnote-ref-2)