

APPENDIX

7B

BANKRUPTCY AND REORGANIZATION

In the event of bankruptcy, debtholders have a prior claim to a firm's income and assets over the claims of both common and preferred stockholders. Further, different classes of debtholders are treated differently in the event of bankruptcy. Since bankruptcy is a fairly common occurrence, and since it affects both the bankrupt firm and its customers, suppliers, and creditors, it is important to know who gets what if a firm fails. These topics are discussed in this appendix.¹

FEDERAL BANKRUPTCY LAWS

Bankruptcy actually begins when a firm is unable to meet scheduled payments on its debt or when the firm's cash flow projections indicate that it will soon be unable to meet payments. As the bankruptcy proceedings go forward, the following central issues arise:

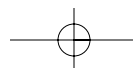
1. Does the firm's inability to meet scheduled payments result from a temporary cash flow problem, or does it represent a permanent problem caused by asset values having fallen below debt obligations?
2. If the problem is a temporary one, then an agreement that stretches out payments may be worked out to give the firm time to recover and to satisfy everyone. However, if basic long-run asset values have truly declined, economic losses will have occurred. In this event, who should bear the losses?
3. Is the company "worth more dead than alive"—that is, would the business be more valuable if it were maintained and continued in operation or if it were liquidated and sold off in pieces?
4. Who should control the firm while it is being liquidated or rehabilitated? Should the existing management be left in control, or should a trustee be placed in charge of operations?

These are the primary issues that are addressed in the federal bankruptcy statutes.

Our bankruptcy laws were first enacted in 1898, modified substantially in 1938, changed again in 1978, and further fine-tuned in 1984. The 1978 Act, which provides the basic laws that govern bankruptcy today, was a major revision designed to streamline and expedite proceedings, and it consists of eight odd-numbered chapters, the even-numbered chapters of the earlier Act having been deleted. Chapters 1, 3,

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¹ Much of the current work in this area is based on writings by Edward I. Altman. For a summary of his work, and that of others, see Edward I. Altman, "Bankruptcy and Reorganization," in *Handbook of Corporate Finance*, Edward I. Altman, ed. (New York: Wiley, 1986), Chapter 19.



and 5 of the 1978 Act contain general provisions applicable to the other chapters; Chapter 7 details the procedures to be followed when liquidating a firm; Chapter 9 deals with financially distressed municipalities; Chapter 11 is the business reorganization chapter; Chapter 13 covers the adjustment of debts for “individuals with regular income”; and Chapter 15 sets up a system of trustees who help administer proceedings under the Act.

Chapters 11 and 7 are the most important ones for financial management purposes. When you read in the paper that McCrory Corporation or some other company has “filed for Chapter 11,” this means that the company is bankrupt and is trying to reorganize under Chapter 11 of the Act. If a reorganization plan cannot be worked out, then the company will be liquidated as prescribed in Chapter 7 of the Act.

The 1978 Act is quite flexible, and it provides a great deal of scope for informal negotiations between a company and its creditors. Under this Act, a case is opened by the filing of a petition with a federal district bankruptcy court. The petition may be either voluntary or involuntary—that is, it may be filed either by the firm’s management or by its creditors. A committee of unsecured creditors is then appointed by the court to negotiate with management for a reorganization, that may include the restructuring of debt and other claims against the firm. (A “restructuring” could involve lengthening the maturity of debt, lowering the interest rate on it, reducing the principal amount owed, exchanging common or preferred stock for debt, or some combination of these actions.) A trustee may be appointed by the court if that is deemed to be in the best interests of the creditors and stockholders; otherwise, the existing management will retain control. If no fair and feasible reorganization can be worked out under Chapter 11, the firm will be liquidated under the procedures spelled out in Chapter 7.

FINANCIAL DECISIONS IN BANKRUPTCY

When a business becomes insolvent, a decision must be made whether to dissolve the firm through *liquidation* or to keep it alive through *reorganization*. To a large extent, this decision depends on a determination of the value of the firm if it is rehabilitated versus the value of its assets if they are sold off individually. The procedure that promises higher returns to the creditors and owners will be adopted. However, the “public interest” will also be considered, and this generally means attempting to salvage the firm, even if the salvaging effort may be costly to bondholders. For example, the bankruptcy court kept Eastern Airlines alive, at the cost of millions of dollars that could have been paid to bondholders, until it was obvious even to the judge that Eastern could not be saved. Note, too, that if the decision is made to reorganize the firm, the courts and possibly the SEC will be called upon to determine the fairness and the feasibility of the proposed reorganization plan.

Standard of Fairness

The basic doctrine of *fairness* states that claims must be recognized in the order of their legal and contractual priority. Carrying out this concept of fairness in a reorganization (as opposed to a liquidation) involves the following steps:

1. Future sales must be estimated.
2. Operating conditions must be analyzed so that the future earnings and cash flows can be predicted.

3. A capitalization (or discount) rate to be applied to these future cash flows must be determined.
4. This capitalization rate must then be applied to the estimated cash flows to obtain a present value figure, which is the indicated value for the reorganized company.
5. Provisions for the distribution of the restructured firm's securities to its claimants must be made.

Standard of Feasibility

The primary test of *feasibility* in a reorganization is whether the fixed charges after reorganization can be covered by cash flows. Adequate coverage generally requires an improvement in operating earnings, a reduction of fixed charges, or both. Among the actions that generally must be taken are the following:

1. Debt maturities are usually lengthened, interest rates may be scaled back, and some debt may be converted into equity.
2. When the quality of management has been substandard, a new team must be given control of the company.
3. If inventories have become obsolete or depleted, they must be replaced.
4. Sometimes the plant and equipment must be modernized before the firm can operate on a competitive basis.

LIQUIDATION PROCEDURES

If a company is too far gone to be reorganized, it must be liquidated. Liquidation should occur if a business is worth more dead than alive, or if the possibility of restoring it to financial health is so remote that the creditors would face a high risk of even greater losses if operations were continued.

Chapter 7 of the Bankruptcy Act is designed to do three things: (1) provide safeguards against the withdrawal of assets by the owners of the bankrupt firm, (2) provide for an equitable distribution of the assets among the creditors, and (3) allow insolvent debtors to discharge all of their obligations and to start over unhampered by a burden of prior debt.

The distribution of assets in a liquidation under Chapter 7 of the Bankruptcy Act is governed by the following priority of claims:

1. *Secured creditors, who are entitled to the proceeds of the sale of specific property pledged for a lien or a mortgage.* If the proceeds do not fully satisfy the secured creditors' claims, the remaining balance is treated as a general creditor claim. (See Item 9.)
2. *Trustee's costs to administer and operate the bankrupt firm.*
3. *Expenses incurred after an involuntary case has begun but before a trustee is appointed.*
4. *Wages due workers if earned within three months prior to the filing of the petition of bankruptcy.* The amount of wages is limited to \$2,000 per person.
5. *Claims for unpaid contributions to employee benefit plans that were to have been paid within six months prior to filing.* However, these claims, plus wages in Item 4, are not to exceed the \$2,000 per employee limit.

6. *Unsecured claims for customer deposits, not to exceed a maximum of \$900 per individual.*
7. *Taxes due to federal, state, county, and any other government agency.*
8. *Unfunded pension plan liabilities.* Unfunded pension plan liabilities have a claim above that of the general creditors for an amount up to 30 percent of the common and preferred equity; any remaining unfunded pension claims rank with the general creditors.
9. *General, or unsecured, creditors.* Holders of trade credit, unsecured loans, the unsatisfied portion of secured loans, and debenture bonds are classified as *general creditors*. Holders of subordinated debt also fall into this category, but they must turn over required amounts to the holders of senior debt, as discussed later in this section.
10. *Preferred stockholders, who can receive an amount up to the par value of the issue.*
11. *Common stockholders, who receive any remaining funds.*

To illustrate how this priority system works, consider the balance sheet of Chiefland Inc., shown in Table 7B-1. The assets have a book value of \$90 million. The claims are indicated on the right side of the balance sheet. Note that the debentures are subordinate to the notes payable to banks. Chiefland had filed for reorganization under Chapter 11, but since no fair and feasible reorganization could be arranged, the trustee is liquidating the firm under Chapter 7. The firm also has \$15 million of unfunded pension liabilities.²

The assets as reported in the balance sheet in Table 7B-1 are greatly over-stated; they are, in fact, worth about half of the \$90 million at which they are carried. The following amounts are realized on liquidation:

Proceeds from sale of current assets	\$41,950,000
Proceeds from sale of fixed assets	<u>5,000,000</u>
Total receipts	<u>\$46,950,000</u>

The allocation of available funds is shown in Table 7B-2. The holders of the first mortgage bonds receive the \$5 million of net proceeds from the sale of fixed assets. Note that a \$1 million unsatisfied claim of the first mortgage holders remains;

² Under the federal statutes that regulate pension funds, corporations are required to estimate the amount of money needed to provide for the pensions that have been promised to their employees. This determination is made by professional actuaries, taking into account when employees will retire, how long they are likely to live, and the rate of return that can be earned on pension fund assets. If the assets currently in the pension fund are deemed sufficient to make all required payments, the plan is said to be *fully funded*. If assets in the plan are less than the present value of expected future payments, an *unfunded liability* exists. Under federal laws, companies are given up to 30 years to fund any unfunded liabilities. (Note that if a company were fully funded in 2002, but then agreed in 2003 to double pension benefits, this would immediately create a large unfunded liability, and it would need time to make the adjustment. Otherwise, it would be difficult for companies to agree to increase pension benefits.)

Unfunded pension liabilities, including medical benefits to retirees, represent a time bomb ticking in the bowels of many companies. If a company has a relatively old labor force, and if it has promised them substantial retirement benefits but has not set aside assets in a funded pension fund to cover these benefits, it could experience severe trouble in the future. These unfunded pension benefits could even drive the company into bankruptcy, at which point the pension plan would be subject to the bankruptcy laws.

TABLE 7B-1

**Chiefland Inc.: Balance Sheet Just before Liquidation
(Thousands of Dollars)**

Current assets	\$80,000	Accounts payable	\$20,000
Net fixed assets	10,000	Notes payable (to banks)	10,000
		Accrued wages, 1,400 @ \$500	700
		U.S. taxes	1,000
		State and local taxes	<u>300</u>
		Current liabilities	<u>\$32,000</u>
		First mortgage	6,000
		Second mortgage	1,000
		Subordinated debentures ^a	<u>8,000</u>
		Total long-term debt	<u>\$15,000</u>
		Preferred stock	2,000
		Common stock	26,000
		Paid-in capital	4,000
		Retained earnings	<u>11,000</u>
		Total equity	<u>\$43,000</u>
Total assets	<u>\$90,000</u>	Total liabilities and equity	<u>\$90,000</u>

^aSubordinated to \$10 million of notes payable to banks.

NOTE: Unfunded pension liabilities are \$15 million; this is not reported on the balance sheet.

this claim is added to those of the other general creditors. Next come the fees and expenses of administration, which are typically about 20 percent of gross proceeds; in this example, they are assumed to be \$6 million. Next in priority are wages due workers, which total \$700,000; taxes due, which amount to \$1.3 million; and unfunded pension liabilities of up to 30 percent of the common plus preferred equity, or \$12.9 million. Thus far, the total of claims paid from the \$46.95 million is \$25.90 million, leaving \$21.05 million for the general creditors.

The claims of the general creditors total \$42.1 million. Since \$21.05 million is available, claimants will initially be allocated 50 percent of their claims, as shown in Column 2 of Table 7B-2, before the subordination adjustment. This adjustment requires that the holders of subordinated debentures turn over to the holders of notes payable all amounts received until the notes are satisfied. In this situation, the claim of the notes payable is \$10 million, but only \$5 million is available; the deficiency is therefore \$5 million. After transfer of \$4 million from the subordinated debentures, there remains a deficiency of \$1 million on the notes. This amount will remain unsatisfied.

Note that 92 percent of the first mortgage, 90 percent of the notes payable, and 93 percent of the unfunded pension fund claims are satisfied, whereas a maximum of 50 percent of unsecured claims will be satisfied. These figures illustrate the usefulness of the subordination provision to the security to which the subordination is made. Because no other funds remain, the claims of the holders of preferred and common stock are completely wiped out. Studies of bankruptcy liquidations indicate that unsecured creditors receive, on the average, about 15 cents on the dollar, whereas common stockholders generally receive nothing.

TABLE 7B - 2

Chiefland Inc.: Order of Priority of Claims

DISTRIBUTION OF PROCEEDS ON LIQUIDATION

1. Proceeds from sale of assets		\$46,950,000
2. First mortgage, paid from sale of fixed assets	\$ 5,000,000	
3. Fees and expenses of administration of bankruptcy	6,000,000	
4. Wages due workers earned within three months prior to filing of bankruptcy petition	700,000	
5. Taxes	1,300,000	
6. Unfunded pension liabilities ^a	12,900,000	25,900,000
7. Available to general creditors		<u>\$21,050,000</u>

DISTRIBUTION TO GENERAL CREDITORS

CLAIMS OF GENERAL CREDITORS	CLAIM ^b (1)	APPLICATION OF 50 PERCENT ^c (2)	AFTER SUBORDINATION ADJUSTMENT ^d (3)	PERCENTAGE OF ORIGINAL CLAIMS RECEIVED ^e (4)
Unsatisfied portion of first mortgage	\$ 1,000,000	\$ 500,000	\$ 500,000	92%
Unsatisfied portion of second mortgage	1,000,000	500,000	500,000	50
Notes payable	10,000,000	5,000,000	9,000,000	90
Accounts payable	20,000,000	10,000,000	10,000,000	50
Subordinated debentures	8,000,000	4,000,000	0	0
Pension plan	2,100,000	1,050,000	1,050,000	93
	<u>\$42,100,000</u>	<u>\$21,050,000</u>	<u>\$21,050,000</u>	

^a Unfunded pension liabilities are \$15,000,000, and common and preferred equity total \$43,000,000. Unfunded pension liabilities have a prior claim of up to 30 percent of the total equity, or \$12,900,000, with the remainder, \$2,100,000, being treated as a general creditor claim.

^b Column 1 is the claim of each class of general creditor. Total claims equal \$42.1 million.

^c From Line 7 in the upper section of the table, we see that \$21.05 million is available for general creditors. This sum, divided by the \$42.1 million of claims, indicates that general creditors will initially receive 50 percent of their claims; this is shown in Column 2.

^d The debentures are subordinated to the notes payable, so \$4 million is reallocated from debentures to notes payable in Column 3.

^e Column 4 shows the results of dividing the amount in Column 3 by the original claim amount given in Column 1, except for the first mortgage, for which the \$5 million received from the sale of fixed assets is included, and the pension plan, for which the \$12.9 million is included.

SOCIAL ISSUES IN BANKRUPTCY PROCEEDINGS

An interesting social issue arose in connection with bankruptcy during the 1980s—the role of bankruptcy in settling labor disputes and product liability suits. Normally, bankruptcy proceedings originate after a company has become so financially weak that it cannot meet its current obligations. However, provisions in the Bankruptcy Act permit a company to file for protection under Chapter 11 if *financial forecasts* indicate that a continuation of business under current conditions will lead to insolvency. These provisions were applied by Frank Lorenzo, the principal stockholder of Continental Airlines, who demonstrated that if Continental continued to operate under its then-current union contract, it would become insolvent in a matter of months.

The company then filed a plan of reorganization that included major changes in its union contract. The court found for Continental and allowed the company to abrogate its contract. It then reorganized as a nonunion carrier, and that reorganization turned the company from a money loser into a money maker. (However, in 1990, Continental's financial situation reversed again, partly due to rising fuel prices, and the company once again filed for bankruptcy.) Under pressure from labor unions, Congress changed the bankruptcy laws after the Continental affair to make it more difficult to use the laws to break union contracts.

The bankruptcy laws have also been used to bring about settlements in major product liability suits, the Manville asbestos case being the first, followed by the Dalkon Shield case. In both instances, the companies were being bombarded by literally thousands of lawsuits, and the very existence of such huge contingent liabilities made continued operations virtually impossible. Further, in both cases, it was relatively easy to prove (1) that if the plaintiffs won, the companies would be unable to pay off the full amounts claimed, (2) that a larger amount of funds would be available if the companies continued to operate than if they were liquidated, (3) that continued operations were possible only if the suits were brought to a conclusion, and (4) that a timely resolution of all the suits was impossible because of the number of suits and the different positions taken by different parties. At any rate, the bankruptcy statutes were used to consolidate all the suits and to reach a settlement under which all the plaintiffs obtained more money than they otherwise would have gotten, and the companies were able to stay in business. The stockholders did not do very well because most of the companies' future cash flows were assigned to the plaintiffs, but, even so, the stockholders probably came out better than they would have if the individual suits had been carried through the jury system to a conclusion.

In the Johns-Manville Corporation case, the decision to reorganize was heavily influenced by the prospect of an imminent series of lawsuits. Johns-Manville, a profitable building supplier, faced increasing liabilities resulting from the manufacture of asbestos. When thousands of its employees and consumers were found to be exposed, Johns-Manville filed for Chapter 11 bankruptcy protection and set up a trust fund for the victims as part of its reorganization plan. Present and future claims for exposure were to be paid out of this fund. However, it was later determined that the trust fund was significantly underfunded due to more and larger claims than had been originally estimated.

We have no opinion about the use of the bankruptcy laws to settle social issues such as labor disputes and product liability suits. However, the examples do illustrate how financial projections can be used to demonstrate the effects of different legal decisions. Financial analysis is being used to an increasing extent in various types of legal work, from antitrust cases to suits against stockbrokers by disgruntled customers, and this trend is likely to continue.

PROBLEMS**7B-1**
Bankruptcy distributions

The H. Quigley Marble Company has the following balance sheet:

Current assets	\$5,040	Accounts payable	\$1,080
Fixed assets	2,700	Notes payable (to bank)	540
		Accrued taxes	180
		Accrued wages	180
		Total current liabilities	<u>\$1,980</u>
		First mortgage bonds	900
		Second mortgage bonds	900
		Total mortgage bonds	<u>\$1,800</u>
		Subordinated debentures	<u>1,080</u>
		Total debt	<u>\$4,860</u>
		Preferred stock	360
		Common stock	<u>2,520</u>
Total assets	<u>\$7,740</u>	Total liabilities and equity	<u>\$7,740</u>

The debentures are subordinated only to the notes payable. Suppose the company goes bankrupt and is liquidated, with \$1,800 being received from the sale of the fixed assets, which were pledged as security for the first and second mortgage bonds, and \$2,880 received from the sale of current assets. The trustee's costs total \$480. How much will each class of investors receive?

7B-2
Bankruptcy distributions

Southwestern Wear Inc. has the following balance sheet:

Current assets	\$1,875,000	Accounts payable	\$375,000
Fixed assets	1,875,000	Notes payable	750,000
		Subordinated debentures	<u>750,000</u>
		Total debt	<u>\$1,875,000</u>
		Common equity	<u>1,875,000</u>
Total assets	<u>\$3,750,000</u>	Total liabilities and equity	<u>\$3,750,000</u>

The trustee's costs total \$281,250, and the firm has no accrued taxes or wages. The debentures are subordinated only to the notes payable. If the firm goes bankrupt, how much will each class of investors receive under each of the following conditions?

- A total of \$2.5 million is received from sale of the assets.
- A total of \$1.875 million is received from sale of the assets.