CHAPTER 25

Bankruptcy, Reorganization, and Liquidation
Topics in Chapter

- Financial distress process
- Federal bankruptcy law
- Reorganization
- Liquidation
What are the major causes of business failure?

- Economic factors
  - industry weakness
  - poor location/product
- Financial factors
  - too much debt
  - insufficient capital
- Most failures occur because a number of factors combine to make the business unsustainable.
Do business failures occur evenly over time?

- A large number of businesses fail each year, but the number in any one year has never been a large percentage of the total business population.
- The failure rate of businesses has tended to fluctuate with the state of the economy.
What size firm, large or small, is more prone to business failure?

- Bankruptcy is more frequent among smaller firms.
- Large firms tend to get more help from external sources to avoid bankruptcy, given their greater impact on the economy.
What key issues must managers face in the financial distress process?

- Is it a temporary problem (technical insolvency) or a permanent problem caused by asset values below debt obligations (insolvency in bankruptcy)?
- Who should bear the losses?
- Would the firm be more valuable if it continued to operate or if it were liquidated?
Key Issues (Continued)

- Should the firm file for bankruptcy, or should it try to use informal procedures?
- Who would control the firm during liquidation or reorganization?
What informal remedies are available to firms in financial distress?

- Informal reorganization
- Informal liquidation

Why might informal remedies be preferable to formal bankruptcy?

What types of companies are most suitable for informal remedies?
Informal Bankruptcy Terminology

- **Workout:** Voluntary informal reorganization plan.

- **Restructuring:** Current debt terms are revised to facilitate the firm’s ability to pay.
  - **Extension:** Creditors postpone the dates of required interest or principal payments, or both. Creditors prefer extension because they are promised eventual payment in full.
Composition: Creditors voluntarily reduce their fixed claims on the debtor by either accepting a lower principal amount or accepting equity in lieu of debt repayment.

Assignment: An informal procedure for liquidating a firm’s assets. Title to the debtor’s assets is transferred to a third party, called a trustee or assignee, and then the assets are sold off.
Describe the following terms related to U.S. bankruptcy law:

- Chapter 11: Business reorganization guidelines.
- Chapter 7: Liquidation procedures.
- Trustee:
  - Appointed to control the company when current management is incompetent or fraud is suspected.
  - Used only in unusual circumstances.
Voluntary bankruptcy: A bankruptcy petition filed in federal court by the distressed firm’s management.

Involuntary bankruptcy: A bankruptcy petition filed in federal court by the distressed firm’s creditors.
What are the major differences between an informal reorganization and reorganization in bankruptcy?

- **Informal Reorganization:**
  - Less costly
  - Relatively simple to create
  - Typically allows creditors to recover more money and sooner.

(More...)
Reorganization in Bankruptcy

- Avoids holdout problems.
- Due to automatic stay provision, avoids common pool problem.
- Interest and principal payments may be delayed without penalty until reorganization plan is approved.
- Permits the firm to issue debtor in possession (DIP) financing.
- Gives debtor exclusive right to submit a proposed reorganization plan for agreement from the parties involved.
- Reduces fraudulent conveyance problem.
- Cramdown if majority in each creditor class approve plan.
What is a prepackaged bankruptcy?

- New type of reorganization
  - Combines the advantages of both formal and informal reorganizations.
  - Avoids holdout problems
  - Preserves creditors’ claims
  - Favorable tax treatment.

- Agreement to plan obtained from creditors prior to filing for bankruptcy.

- Plan filed with bankruptcy petition.
List the priority of claims in a Chapter 7 liquidation.

- Secured creditors.
- Trustee’s administrative costs.
- Expenses incurred after involuntary case begun but before trustee appointed.
- Wages due workers within 3 months prior to filing.

(More... )
- Unpaid contributions to employee benefit plans that should have been paid within 6 months prior to filing.
- Unsecured claims for customer deposits.
- Taxes due.
- Unfunded pension plan liabilities.
- General (unsecured) creditors.
- Preferred stockholders.
- Common stockholders.
## Liquidation Illustration Data (millions of $)

<table>
<thead>
<tr>
<th>Creditor Claims</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$10.0</td>
</tr>
<tr>
<td>Notes payable</td>
<td>5.0</td>
</tr>
<tr>
<td>Accrued wages</td>
<td>0.3</td>
</tr>
<tr>
<td>Federal taxes</td>
<td>0.5</td>
</tr>
<tr>
<td>State and local taxes</td>
<td>0.2</td>
</tr>
<tr>
<td>First mortgage</td>
<td>3.0</td>
</tr>
<tr>
<td>Second mortgage</td>
<td>0.5</td>
</tr>
<tr>
<td>Subordinated debentures*</td>
<td>4.0</td>
</tr>
<tr>
<td></td>
<td><strong>$23.5</strong></td>
</tr>
</tbody>
</table>

Subordinated to notes payable.
Proceeds from Liquidation

From current assets $14.0

From fixed assets* 2.5

Total receipts $16.5

*All fixed assets pledged as collateral to mortgage holders.
## Priority Distribution
(millions of $)

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Claim</th>
<th>Distribution</th>
<th>Unsatisfied</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued wages</td>
<td>$0.3</td>
<td>$0.3</td>
<td>$0.0</td>
</tr>
<tr>
<td>Federal taxes</td>
<td>0.5</td>
<td>0.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Other taxes</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>First mortgage</td>
<td>3.0</td>
<td>2.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Second mortgage</td>
<td>0.5</td>
<td>0.0</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$4.5</strong></td>
<td><strong>$3.5</strong></td>
<td><strong>$1.0</strong></td>
</tr>
</tbody>
</table>

Notes: (1) First mortgage receives entire proceeds from sale of fixed assets, leaving $0 for the second mortgage. (2) $16.5 - $3.5 = $13.0 remains for distribution to general creditors.
# General Creditor Distribution

(millions of $)

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Remaining GC Claim</th>
<th>Initial Distr.(^a)</th>
<th>Final Amt.(^b)</th>
<th>% Recd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$10.0</td>
<td>$6.500</td>
<td>$6.500</td>
<td>65.0%</td>
</tr>
<tr>
<td>Notes payable</td>
<td>5.0</td>
<td>3.250</td>
<td>5.000</td>
<td>100.0</td>
</tr>
<tr>
<td>Accrued wages</td>
<td>0.0</td>
<td>0.300</td>
<td></td>
<td>100.0</td>
</tr>
<tr>
<td>Federal taxes</td>
<td>0.0</td>
<td>0.500</td>
<td></td>
<td>100.0</td>
</tr>
<tr>
<td>Other taxes</td>
<td>0.0</td>
<td>0.200</td>
<td></td>
<td>100.0</td>
</tr>
<tr>
<td>First mortgage</td>
<td>0.5</td>
<td>0.325</td>
<td>2.825</td>
<td>94.2</td>
</tr>
<tr>
<td>Second mortgage</td>
<td>0.5</td>
<td>0.325</td>
<td>0.325</td>
<td>65.0</td>
</tr>
<tr>
<td>Sub. debentures</td>
<td>4.0</td>
<td>2.600</td>
<td>0.850</td>
<td>21.2</td>
</tr>
</tbody>
</table>

**Total** $20.0 $13.000 $16.500

\(^a\) Pro rata amount = $13/$20 = 0.65.

\(^b\) Includes priority distribution and $1.75 transfer from subordinated debentures.
Other Motivations for Bankruptcy

- Normally, bankruptcy is motivated by serious current financial problems.
- However, some companies have used bankruptcy proceedings for other purposes:
  - To break union contracts
  - To hasten liability settlements
Some Criticisms of Bankruptcy Laws

- Critics contend that current bankruptcy laws are flawed.
- Too much value is siphoned off by lawyers, managers, and trustees.
- Companies that have no hope remain alive too long, leaving little for creditors when liquidation does occur.
- Companies in bankruptcy can hurt other companies in industry.
Recent Bankruptcy Law Changes

- The 2005 changes to the bankruptcy laws:
  - Limited to 18 months the time management has until it must file a reorganization plan.
  - After the 18 months, creditors can propose a plan if an acceptable plan hasn’t been proposed by management.