
Bankruptcy

Top 15 Bankruptcies 1980 - Present

Company	Bankruptcy Date	Total Pre-Bankruptcy Assets	Filing Court District
<u>Worldcom, Inc.</u>	7/21/2002	\$103,914,000,000	NY-S
<u>Enron Corp.*</u>	12/2/2001	\$63,392,000,000	NY-S
<u>Conseco, Inc.</u>	12/18/2002	\$61,392,000,000	IL-N
<u>Texaco, Inc.</u>	4/12/1987	\$35,892,000,000	NY-S
<u>Financial Corp. of America</u>	9/9/1988	\$33,864,000,000	CA-C
<u>Global Crossing Ltd.</u>	1/28/2002	\$30,185,000,000	NY-S
<u>UAL Corp.</u>	12/9/2002	\$25,197,000,000	IL-N
Adelphia Communications	6/25/2002	\$21,499,000,000	NY-S
<u>Pacific Gas and Electric Co.</u>	4/6/2001	\$21,470,000,000	CA-N
<u>MCorp</u>	3/31/1989	\$20,228,000,000	TX-S
<u>Mirant Corporation</u>	7/14/2003	\$19,415,000,000	TX-N
<u>First Executive Corp.</u>	5/13/1991	\$15,193,000,000	CA-C
<u>Gibraltar Financial Corp.</u>	2/8/1990	\$15,011,000,000	CA-C
<u>Kmart Corp.</u>	1/22/2002	\$14,600,000,000	IL-N
<u>The FINOVA Group, Inc.</u>	3/7/2001	\$14,050,000,000	DE

Objective of Bankruptcy Law

- Primary goal is to maximize the value of the distressed firm's assets
 - » Liquidation
 - » Reorganization
- Maximizing asset value also maximizes aggregate value available to be distributed to stakeholders
 - » Suppliers
 - » Employees
 - » Creditors
 - » Shareholders
- Cost of bankruptcy, and length of bankruptcy cases, are driven by disagreements among stakeholders

Bankruptcy Code Description

Primary Players

- Judge
- Debtor
- Creditors
- Bankruptcy Trustee
 - » Bankruptcy trustees are primarily involved in Chapter 7 liquidations. They are responsible for liquidating assets and distributing proceeds to stakeholders
- United States Trustee
 - » Administrative employee of the Department of Justice that appoints Bankruptcy Trustees and carries out other administrative tasks in the bankruptcy process.

Primary Players (continued)

- Debtor in Possession

- » Most often consists of existing management
- » Has fiduciary responsibility to all of the firm's stakeholders, not just shareholders.

- Creditors Committee

- » Representatives of creditors
- » Appointed by the Judge or the Bankruptcy Trustee
- » Tasked with overseeing the Debtor in Possession and assisting with the formulation and confirmation of the bankruptcy plan.

Who Can File for Bankruptcy?

- Voluntary - managers realize the firm is insolvent and file for bankruptcy court protection.
 - » Must file in district in which, for the 180 days prior to filing, is the primary place of business and is where the majority of the firm's assets reside
 - » Venue shopping is not uncommon
- Involuntary - creditors, fearing that managers, equity holders, or other creditors are absconding with the firm's assets, file to force the debtor into bankruptcy
 - » Goal is to force oversight by the bankruptcy court
 - » Involuntary filings require at least three unsecured creditors with claims in excess of \$5,000
 - » Just another lawsuit...debtor has the right to defend itself
 - » While the suit proceeds, the debtor gets the benefits of bankruptcy protection without having to get court approval of business decisions

Types of Bankruptcy

- Bankruptcy Code has “Chapters”
 - » Chapters 1 – General Provisions
 - » Chapters 3 – Case Administration
 - » Chapter 5 – Creditors, the Debtor and the Estate
 - » **Chapter 7 – Liquidation**
 - » Chapter 9 – Adjustments of Debts of a Municipality
 - » **Chapter 11 – Reorganization**
 - » Chapter 12 – Adjustments of Debts of a Family Farmer with Regular Annual Income
 - » Chapter 13 – Adjustments of Debts of an Individual with Regular Income
- Corporations are generally concerned with Chapters 7 and 11

Chapter 7 Liquidation

- General Procedure
 - » Bankruptcy Trustee appointed
 - » Assets liquidated
 - » Proceeds distributed to stakeholders according to the Absolute Priority Rule
- Debtor has the right to transform an involuntary Chapter 7 into a Chapter 11
- The court can transform a Chapter 11 reorganization into a Chapter 7 liquidation

Chapter 11 Reorganization

- Chapter 11 imposes an automatic stay on creditors and gives incumbent management the exclusive right to file a reorganization plan for 120 days. Objectives are to:
 - » Exchange old claims on assets for new ones thereby reducing the amount of debt in the capital structure.
 - » Restructure assets to make the firm an economically viable entity.
- Managers can request, and are often granted, an extension to the 120 exclusivity period.
- Acceptance of the plan requires acceptance by *each* class of creditors (2/3 by \$, 1/2 by number) including equityholders → HOLD-UP PROBLEMS.

Debtor Benefits in Chapter 11

- Automatic stay prevents a run on assets
 - » Creditors cannot seek enforcement of liens
 - » Creditors cannot seize collateral (except for Sec. 2110 creditors)
 - To compensate secured creditors for giving up their right to seize collateral, they are given “adequate protection” (e.g. additional liens)
 - The economic value of the “adequate protection” depends on creditors’ negotiating power (likely driven by the necessity of the secured assets)
- Existing management team retains control of operations
- Interest ceases to accrue on the filing date

Debtor Benefits in Chapter 11 (cont.)

- Pre-filing contracts can be “assumed”
 - » Assuming a contract requires the debtor to:
 - Make all past due payments
 - Pay damages
 - Provide adequate guarantee that future payments will be made
 - » Counterparty may prefer not to have contract assumed. However, contract clauses that state that the contract cannot be assumed in bankruptcy are generally unenforceable
- Pre-filing contracts can be “rejected”
 - » Bankruptcy protection essentially allows companies to breach prior contracts without penalty
- Court approval is required for assumption or rejection of contracts (business judgement standard applies)

Asset Allocation in Bankruptcy

- Assets and new securities are (theoretically) allocated according to the Absolute Priority Rule:
 1. Secured claims
 2. Debtor-in-possession claims
 3. Priority claims (legal fees, wages,...)
 4. General unsecured claims
 5. Preferred stock
 6. Common stock
- **APR is often violated** (Betker (1995), Altman (1993), Franks and Torous (1994)...)
 - » Some courts are worse than others (SDNY and Ionosphere Clubs).

Conflicts of Interest

- Estimated Asset Value

- » Senior creditors have an incentive to deflate estimated asset values
- » Junior creditors have an incentive to inflate estimated asset values
- » Junior creditors can threaten to delay the proceedings, thereby extracting a positive payoff even if senior creditors are impaired
 - Estate pays legal fees for all creditor classes
 - Time value of money

- Preferential and Fraudulent Transfers (pre-filing)

- » Primary question is whether creditor received more than if he/she had participated in bankruptcy process
 - “Look back” period is 90 days before filing
 - “Look back” period is one year for insiders (> 10% common equity ownership)
- » Post-LBO bankruptcies

Bankruptcy Plan

- Creditor Classes

- » Generally attempts to place similar claims in a class
- » Unsecured and secured creditors are almost always in separate classes
- » Classes structured to encourage plan acceptance

- Disclosure Statement

- » Provides information such that an informed decision can be made
- » Subsequently voted on by each *impaired* creditor class
 - Acceptance requires that all classes vote in favor
 - Class acceptance requires 1/2 by number, 2/3 by dollar amount of claim
 - “Best interest test” requires that creditors receive at least as much as they would receive in a Chapter 7 liquidation (but valuations are tricky)
- » Dissenting classes can be “crammed down” (APR must hold)

- Confirmation

“Fresh Start” Accounting

- Fresh Start Rule allows a firm that emerges from Chapter 11 to “write-up” asset values to current market value rather than historical cost
 - » Requires the firm to distribute at least 50% of common stock to creditors
 - » Market values assigned by estimating future cashflows
 - » As much value as possible is assigned to tangible assets (e.g. PP&E)
 - » Remainder is assigned to new asset account called “Reorganization Value in Excess of Amounts Allocable to Identifiable Assets”
- Results in immediately positive book equity and improved financial ratios

Worldcom Reorganization Plan

(July 9, 2003)

Class	Designation	Impairment	Entitled to Vote
Class 1	Other Priority Claims	Unimpaired	No (deemed to accept)
Class 2	Secured Tax Claims	Impaired	Yes
Class 3	Other Secured Claims	Unimpaired	No (deemed to accept)
Class 3A	Bank Settlement Claims	Impaired	Yes
Class 4	Convenience Claims	Impaired	Yes
Class 5	WorldCom Senior Debt Claims	Impaired	Yes
Class 6	WorldCom General Unsecured Claims	Impaired	Yes
Class 7	WorldCom Subordinated Claims	Impaired	No (deemed to reject)
Class 8	WorldCom Equity Interests	Impaired	No (deemed to reject)
Class 9	MCIC Senior Debt Claims	Impaired	Yes
Class 10	MCIC Subordinated Debt Claims	Impaired	No (deemed to reject)
Class 11	Intermedia Senior Debt Claims	Impaired	Yes
Class 12	Intermedia General Unsecured Claims	Impaired	Yes
Class 13	Intermedia Subordinated Debt Claims	Impaired	Yes
Class 14	Intermedia Preferred Stock	Impaired	No (deemed to reject)
Class 15	Intermedia Equity Interests	Impaired	No (deemed to reject)

Worldcom Distribution Examples

4.07. CLASS 6—WORLDCOM GENERAL UNSECURED CLAIMS .

- (a) Impairment and Voting . Class 6 is impaired by the Plan. Each holder of an Allowed WorldCom General Unsecured Claim is entitled to vote to accept or reject the Plan.
- (b) Distributions . On the Effective Date, or as soon thereafter as is practicable, each holder of a WorldCom General Unsecured Claim shall receive (i) 7.14 shares of New Common Stock for each one thousand (\$1,000) dollars of such holder's Allowed WorldCom General Unsecured Claim and (ii) Cash in an amount equal to .1785 multiplied by the Allowed amount of such WorldCom General Unsecured Claim, in full and complete satisfaction of such Allowed Claim.

4.09. CLASS 8—WORLDCOM EQUITY INTERESTS .

- (a) Impairment and Voting . Class 8 is impaired by the Plan. Each holder of a WorldCom Equity Interest is conclusively presumed to have rejected the Plan and is not entitled to vote to accept or reject the Plan.
- (b) Distributions . The holders of WorldCom Equity Interests shall not receive any distributions on account of such interests. On the Effective Date, all WorldCom Equity Interests shall be extinguished.

"CRAM DOWN"

6.02. Nonconsensual Confirmation. If any impaired Class of Claims entitled to vote shall not accept the Plan by the requisite statutory majority provided in section 1126(c) of the Bankruptcy Code, the Debtors reserve the right to amend the Plan in accordance with Section 13.09 of the Plan or undertake to have the Bankruptcy Court confirm the Plan under section 1129(b) of the Bankruptcy Code or both. With respect to impaired Classes of Claims that are deemed to reject the Plan, the Debtors shall request that the Bankruptcy Court confirm the Plan pursuant to section 1129(b) of the Bankruptcy Code.

Pre-Packaged Bankruptcies

("Pre-Packs")

- Advantages of Pre-Packs
 - » Avoids costs of lengthy bankruptcy process where business decisions must be authorized by the court
 - Saves legal fees
 - Minimizes adverse effects on the underlying business
 - » Allows firm to implement an “exchange offer” without unanimous consent of bondholders
 - Trust Indenture Act prohibits changes in coupons, maturity, principal, and other economically relevant terms outside of bankruptcy
 - » Instead requires acceptance by classes... 1/2 by number and 2/3 by dollar value of claim
 - » Mitigates “hold-up” problem by forcing dissenting bondholders to accept terms similar to those received by other bondholders
- No Disclosure Statement required...but information must be disseminated in accordance with securities laws

Chapter 7 vs. Chapter 11

- Effects of the Bankruptcy Code


- » Ex-Post:

- Investment efficiency
 - Asset allocation
 - Proceeds to creditors

- » Ex-Ante:

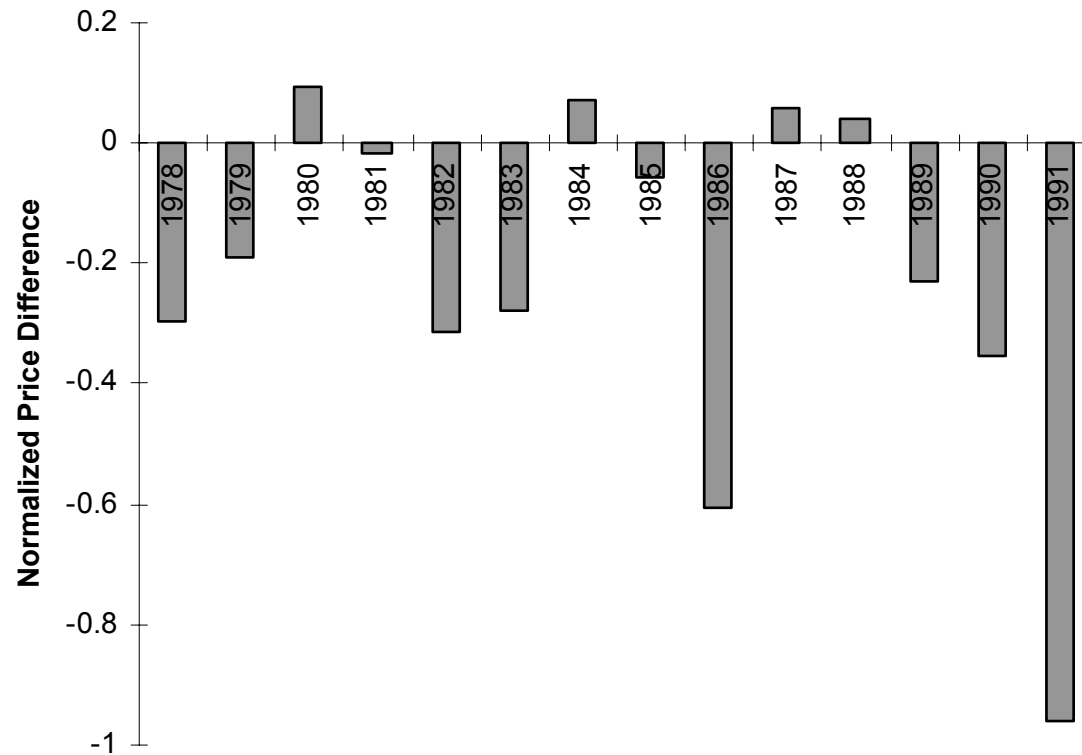
- Capital Structure
 - Investment

- Two views

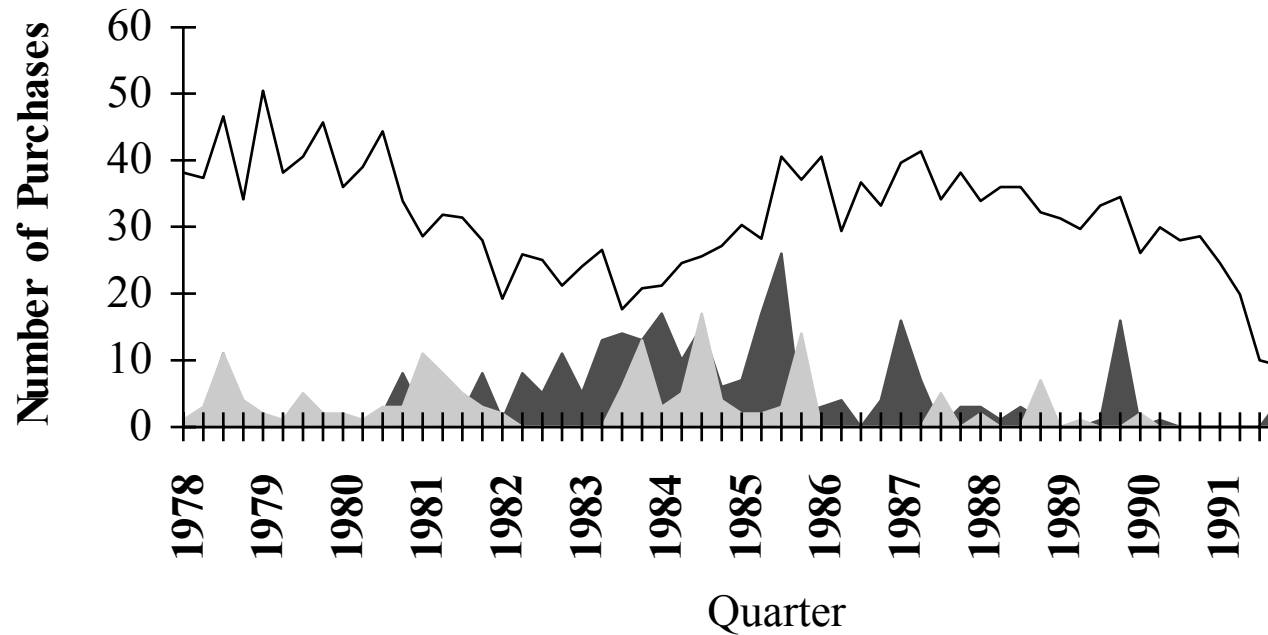
- » Chapter 11 bargaining is inefficient  forced liquidation (Baird 1986, Wruck 1990, Bradley and Rosenzweig 1992, Weiss and Wruck 1998)
 - » Forced liquidation has inefficiencies of its own (Aghion, Hart, and Moore 1992, Shleifer and Vishny 1992)

Used-Aircraft Price Discounts

Effect of Seller's Financial Condition on Transaction Price



Used-Aircraft Purchases



International Bankruptcy Law

- France
 - » Court appointed official helps managers generate a reorganization plan.
 - » Creditors have one representative for all classes.
- U.K.
 - » Administration - accountant or lawyer runs the firm.
 - » Administrative receivership - secured creditors run the firm.
- Japan
 - » Until recently, informal rescues more common than formal bankruptcies.
- Sweden
 - » Court-appointed official auctions the firm.
- Developing Countries...investor beware