Financial Information In The Chapter 11 Process

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ABSTRACT

Although the Chapter 11 filing has occasionally been viewed as a potentially useful management tool, its associated costs are tremendous. Chapter 11 proceedings absorb an enormous portion of management's time. Many formerly routine decisions must now be evaluated by outsiders, who are given legal power to accomplish their own goals. The delays in the decision-making process reduce management's effectiveness.

INTRODUCTION

Chapter 11 of the federal Bankruptcy Code may enable an ailing business to survive its financial distress by protecting its assets from creditors while management attempts to reorder the firm's affairs. Chapter 11 has been used as a powerful management tool in several well-publicized cases. For example, both A. H. Robins Co. and Manville Corp. sought bankruptcy court protection in response to product liability litigation. (1,2) Texaco filed for court protection under Chapter 11 in order to forestall the enforcement of the history-making \$10.3 billion judgment against it that resulted from the acquisition of Getty Oil Co.(3) Continental Airlines and Wheeling-Pittsburgh Steel Corp. dissolved labor contract through Chapter 11 reorganization.(4,5) More recently, Eastern Airlines filed for reorganization in response to the machinists' strike.(6) In addition to its role as a management tool, bankruptcy law can also be used to effect specific macroeconomic goals, such as providing a transition to a smaller steel industry by forcing the steel producers that are under Chapter 11 protection to reorganize in ways that scale down national steel making operations.(7)

In light of the increase in Chapter 11 filings, investors and creditors are seeking to recognize and define the attributes of a failing company.

Although corporate financial statements can be used to predict or anticipate bankruptcy, frequently the timeliness and thoroughness of the information necessary to avoid losses is lacking. Financial statement users expect auditors to provide early warning of failure through "disclaimers" and "going concern exceptions;" however, studies indicate that audit reports have been inadequate in this regard.(8) For example, audit reports for years preceding Chapter 11 filing for Storage Technology Corp. and Manville Corp. did not disclose the extent of those companies' financial dilemmas.

Although most of the current bankruptcy research defines failure as the filing of a Chapter 11 petition, a recent approach focuses on discriminating between Chapter 11 firms that successfully reorganize and those that liquidate.(9) Factors found to have significant discriminating power include the "free assets percentage" (the proportion of assets not secured or pledged at the bankruptcy filing date), the change in profitability in the years immediately preceding filing, and firm size (larger firms generally have greater borrowing capacity). Additionally, manufacturing firms are more likely to successfully reorganize than other types of companies. Bankruptcy attorneys estimate that around 20% of companies

filing for Chapter 11 successfully reorganize,(10) although for publicly-traded firms this number may be as high as 30%.(11)

The economic consequences of liquidation as compared to successful reorganization are tremendous for owners, managers, employees, creditors, suppliers, customers, and those indirectly involved with the distressed firm. If a company's going-concern value exceeds its value in liquidation, every effort should be made to achieve confirmation of the plan of reorganization during Chapter 11 proceedings.(12) The purpose of this article is to describe the role of financial information in facilitating successful organization of the Chapter 11 firm.

II. THE CONTROLLERSHIP FUNCTION IN THE CHAPTER 11 FIRM(13)

Impending financial disaster is frequently caused by inadequacies in the controllership function, especially for small to medium-sized companies. The trouble firms often exhibit a basic lack of financial awareness, evidenced by an inability to answer fundamental financial questions, by financial information being unreliable, and by financial information not being used to manage the company in a proper manner. Financial planning may be lacking or inadequate. The company begins to obtain new borrowings simply to pay down trade debts, and eventually is unable to pay creditors as agreed.

The objective of a Chapter 11 filing is to formulate and obtain creditor and court approval of a plan of reorganization, which operates as a new contract with creditors whereby repayment of debt is restructured. In the typical Chapter 11 situation, management remains in control and the firm operates as a "debtor in possession," with all the rights, powers, and duties of a bankruptcy trustee. The debtor in possession must establish a new set of records, since pre-petition debt is treated substantially differently from post-petition debt. Major differences are outlined in Table 1. The Chapter 11 company and its creditors are temporarily prevented from settling pre-petition debt while a plan of reorganization is developed.

In order for the plan of reorganization to be confirmed, the Bankruptcy Court must find that the plan is in the "best interests of the creditors," meaning that the creditors will receive more under a Chapter 11 reorganization than they would receive in a Chapter 7 liquidation. If the firm has a greater value as a going concern than in liquidation, it will be in the best interests of all to obtain confirmation of the plan of reorganization (Continental Airlines, for example). A cooperative effort between all parties involved is necessary to obtain the financial information essential to preparation of the liquidation and going concern models. Management will be challenged on all of its assumptions, and an operational and financial review of all aspects of the debtor's business will occur in formulating and analyzing the feasibility of the reorganization plan. The controller becomes increasingly important in maintaining the integrity of the firm during this time of crisis.

In order to obtain the necessary post-petition financing required to enable the firm to survive, financial information which is realistic, accurate, and current must be readily available to the debtor in possession as well as to its creditors. The information needs of the troubled firm and its creditors are more acute than those of healthy firms. The budgeting process is critical, as cash needs and projections must be immediately available. If there is no post-petition unsecured credit available, the debtor may experience extreme changes in financing its operations. Suppliers may immediately sever remaining credit lines, and demand c.o.d. or advance payments. The debtor has fewer resources available, and may be unable or unwilling to acquire accounting, legal, or other professional services. The expenditures most likely to enhance survival prospects for the Chapter 11 firm are needed at a time when they are least likely to be made.

A debtor-in-possession may operate its business after filing of the Petition unless the Bankruptcy Court orders otherwise. The debtor may not use cash collateral in the ordinary course of business or otherwise unless the debtor obtains either permission from all creditors with an

interest in the cash collateral or the permission of the Court after notice and hearing to use cash collateral. Until court permission or creditor permission is obtained, the debtor must segregate and account for any cash collateral in its possession, custody or control. Cash collateral includes negotiable instruments, deposit accounts or other cash equivalents, and cash proceeds from the conversion of non-cash collateral such as receivables or inventory which is subject to a pre-petition security interest. Non-cash collateral, which is property of the estate, may be use, sold or leased in the ordinary course of the debtor's business without notice and a hearing. It is very important that the debtor's counsel and accountants be cognizant of the prohibition against the use of cash collateral on a post-petition basis. If the debtor does not have the court's permission or creditors' permission, there are extreme consequences including the appointment of a trustee and the displacement of management. Proceeds from the sale of pre-petition accounts receivable collected post-petition should be segregated in a separate cash collateral account.

The post-petition situation requires financial information on an ongoing basis. In particular, the debtor generally must submit monthly financial affidavits of all expenses and revenues, on both a cash and accrual basis. Creditors monitor these financial affidavits closely to obtain a realistic overview of the debtor's operations. Creditors will be interested in comparisons of actual operating results with budgeted information, including clear and detailed explanations of variances. They need to determine if there is a growing accrual of post-petition debt. If post-petition obligations are accumulating, creditors need to determine the payment priorities of these liabilities, and their eventual impact on payment of pre-petition debts. Creditors will look for "off balance sheet" financing arrangements (for example, lease agreements which have not been capitalized), and will be interested in ongoing operating items such as whether the debtor is maintaining insurance coverage, making required tax payments, etc.

The lack of financial planning which often

contributes to the firm's pre-bankruptcy difficulties may continue post-filing, if the debtor does not have the accounting staff to generate the required information. Specific information needs will include frequent, accurate physical inventories, verification of accounts receivable (especially when they are the basis for post-petition borrowing), aging of accounts receivable and current fair market appraisals of assets. Tables 2 and 3 illustrate disclosures required by the United States Trustee in the Districts of Colorado and Kansas.

Although cooperation is essential in facilitating the flow of financial information required for successful reorganization, management may be reluctant to give creditors an accurate view. This information flow problem is magnified by the fact that the majority of generally accepted accounting principles are based on the going concern assumption, whereas the profession has not developed GAAP for the Chapter 11 firm.

The Chapter 11 process may strain the management - auditor relationship. At this time management may attempt to suppress negative information or select accounting methods that mask the firm's financial condition, creating a breakdown in the auditor-client relationship (loss deferrals, delayed expense recognition, liberal capitalization policies, etc.). It has been demonstrated that failing firms have a greater tendency to switch auditors than do healthier firms.⁽¹⁴⁾ Different auditing firms provide different packages of services. The need of the distressed company may differ from those of healthy companies, increasing the likelihood of an auditor change. Auditor switching may increase audit-related expenditures due to new auditor start-up cost, and is often viewed with suspicion by the financial community. Financial deterioration may create the need for expanded audit procedures, increasing cost at a time when the client is least able to absorb it. Unfortunately, management - auditor problems are likely to occur when they will be most detrimental to creating a spirit of cooperation among the various Chapter 11 parties.

III. CONCLUSION

Although the Chapter 11 filing has occasionally been viewed as a potentially useful management tool, its associated costs are tremendous. Chapter 11 proceedings absorb an enormous portion of management's time. Many formerly routine decisions must now be evaluated by outsiders, who are given legal power to accomplish their own goals. The delays in the decision-making process reduce management's effectiveness.

The bankruptcy court system has been unable to keep pace with the swelling caseload. One-third of the nation's 232 bankruptcy judges have resigned or retired since 1985, leaving the system largely in inexperienced hands.⁽¹⁵⁾ The courts are unable to systematically study the survival prospects of firms petitioning for Chapter 11 reorganization. Apparently, more resources need to be devoted to the bankruptcy court system, and more research is needed to determine the variables that will distinguish firms that can successfully reorganize from those that should liquidate. These variables may include not only financial characteristics of the Chapter 11 firm itself, but also industry-specific and macroeconomic information as well.

References

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- 3 *Wall Street Journal*, "Texaco may Face \$6.5 Billion in Back Income Taxes; IRS Staff Claim Could Complicate Chapter 11 Plan," January 14, 1988, p. 3, 16.
- 4 *Business Week*, "Chapter 11 Isn't so Chic Anymore," June 16, 1986, p. 35.
- 5 Gregory L. Miles, "Chapter 11 is no Panacea for What's Ailing Steel," *Business Week*, August 4, 1986, p. 25.
- 6 Christi Harlan, "Employee Groups, Unsecured Creditors Named to Eastern Creditors Committee," *Wall Street Journal*, March 23, 1989, p. A 6.
- 7 *Business Week*, "Using Bankruptcy to Temper Steel," August 4, 1986, p. 84.
- 8 Christine V. Zavgren, "The Prediction of Corporate Failure: The State of the Art," *Journal of Accounting Literature*, vol. 2, 1983, pp. 1-35.
- 9 Cornelius J. Casey, Victor E. McGee and Clyde P. Stickney, "Discriminating Between Reorganized and Liquidated Firms in Bankruptcy," *Accounting Review*, Vol. LXI, No. 2, April 1986, pp. 249-262.
- 10 Steven P. Galante, "Filing for Bankruptcy may be Best Way to Save the Business," *Wall Street Journal*, March 24, 1986, p.21.
- 11 L. M. LoPucki, "The Debtor in Full Control--Systems Failure under Chapter 11 of the Bankruptcy Code?" *American Bankruptcy Law Journal* (Vol. 57, 1983), pp. 99-126.
- 12 Evidence has been provided suggesting that, in some circumstances, managers who are not also owners may benefit from liquidation more than from continuation: Victor Pastena and William Ruland, "The Merger/Bankruptcy Alternative," *Accounting Review*, Vol. LXI, No. 2, April 1986, pp. 288-301.
- 13 Information contained in this section is based on interviews with legal and accounting practitioners who specialize in Chapter 11 proceedings.
- 14 Kenneth B. Schwartz and Krishnagopal Menon, "Auditor Switches by Failing Firms," *Accounting Review*, Vol. LX, No. 2, April 1986, pp. 248-261.
- 15 Jonathan Dahl and Cynthia F. Mitchell, "Beleaguered Bench: Resignations, Caseload Hurt Bankruptcy Court," *Wall Street Journal*, Dec. 9, 1986, p. 24.

Table 1

Differences between pre-petition and post-petition debt.

<u>Pre-Petition</u>	<u>Post Petition</u>
Cannot pay pre-petition debt.	Must pay debt in the ordinary course of Business.
Priority of payment of prepetition under a plan is established by Bankruptcy Code:	Post-petition priorities are determined by 11 USC S503:
Secured Debt Priorities determined under 11 USC S507 (a) (1)	Administrative Expenses
1. Administrative expenses.	1. Actual and necessary cost and expenses of preserving the estate including wages for services rendered after the commencement of the case including taxes
2. Unsecured claims for involuntary cases.	2. Compensation reimbursement for trustees.
3. Unsecured claims for wages, salaries, or commissions earned by an individual within ninety days before filing to the extent of \$2,000.00	3. Compensation to creditors that benefit the estate under certain circumstances.
4. Unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days before the filing.	4. Attorneys or accountants fees.
5. Unsecured claims for grain storage facilities or proceeds of grain or fish or fish produce to the extent of \$2,000.00.	5. Indenture trustees.
6. Unsecured claims of individuals up to \$900.00 arising from a deposit for the purchase of services or property for the personal family or household use.	
7. Unsecured claims for taxes.	
Use of cash and proceeds from sale of inventory and receivables. As management decides and in accordance with the loan and security document.	Use of cash collateral can only be used by management after court or creditors give permission. This is strictly enforced by the courts.
<u>Payment of Utilities</u>	<u>Payment of Utilities</u>
Pursuant to the applicable tariffs and regulations to be paid in the ordinary course of business.	Adequate assurance of payment must be made. Deposit for 2 to 3 times the average monthly use can be required by utility company as a condition to continuation service.
Pre-petition books and records are closed.	New books and records and debtor--in possession bank accounts must be opened.

DEBTOR: _____

ATTACHMENT #1

CASE NUMBER: _____

INITIAL FINANCIAL REPORT

Unless the United States Trustee otherwise directs, in the event that it is intended to continue the operation of a business, the debtor-in possession or the trustee must file with the United States Trustee, on or before the first meeting of the largest unsecured creditors or within two (2) weeks of the date on the United States Trustee Operating Instructions and Reporting Requirements, a report containing the following information:

1. A copy of the last Balance Sheet prior to the filing of this Chapter 11.

2. A copy of the Income Statement for the month prior to the filing of this Chapter 11 proceeding. The Income Statement for the month of filing will be due by the fifteenth (15) of the following month.

If (1) of (2) above are not available, please explain why.

3. Is Workers' Compensation Insurance in effect? Are the payments current? What is the expiration date? Attach a copy of the binder or cover page of the policy.

4. Are other insurance policies (i.e. fire, liability, etc.) in effect? Are the payments current? What are the expiration dates? Attach a copy of the binder or cover page of the policy.

5. Are federal and state withholding and payroll taxes current? If not, what are the arrearages? Are all post-petition taxes current?

6. Budget projections for reorganization.

a. Prepare a pro forma statement on an accrual basis estimating the revenues, itemizing all expenses, and showing the estimated profit or loss for each month of the first 120 day period of post-petition operations.

b. What is the anticipated amount of cash available for operations during said period?

c. How does the debtor intend to fund the cost of operating for the first 120 day period? Is the use of cash collateral anticipated? Is a request for credit under §164(b), (c) or (d) anticipated?

7. Name and address of bank where the debtor has established its debtor-in-possession account(s). Attach copies of sample check(s) from each account, if available yet.

8. Such other additional information that is pertinent to advise adequately the United States Trustee as to the desirability of continuing the business.

DEBTOR: _____

ATTACHMENT #2

CASE NUMBER: _____

MONTHLY REPORTING AFFIDAVIT FOR PERIOD _____ to _____

1. Were executive salaries paid and were taxes withheld? State amount paid to each executive for the period. Also, include these amounts in gross payroll for #2.

<u>NAME OF EXECUTIVE</u>	<u>COMPENSATION</u>	<u>TAXES DUE</u>	<u>TAXES PAID</u>

2. Were all post-petition wages and federal and state taxes deposited or paid for period? If any post-petition taxes are delinquent, please explain on a separate page. State the amounts requested below.

<u>Type of Tax</u>	<u>GROSS PAYROLL DUE:</u>	<u>Amount Withheld</u>	<u>AMOUNT PAID:</u>	<u>Amount Deposited</u>	<u>Amount Paid</u>

Withholding

FICA

Employee's share

Employer's share

Sales

FUTA

State Withholding

State Unemployment

Personal Property

Other

3. Is Workers' Compensation Insurance and other insurance in effect? Are payments current? If any policy has lapsed and been replaced or renewed, attach a copy of the binder or cover page of new policy.

4. List the post-petition debts accrued that have not been paid. Indicate aging (30, 60, 90 days old). Please explain why these debts have not been paid or indicate when scheduled payment date is.

	<u>Amount</u>	<u>Age</u>	<u>Payment Date</u>
Attorney's fees			
Other Professional fees			
Secured debt/interest payments			
Trade debt			
Rent			
Other			

I declare under penalty of perjury that this Report and attached Statements are true and correct to the best of my knowledge and belief.

DATED: _____

DEBTOR: _____

PLEASE ATTACH ADDITIONAL SCHEDULES IF NECESSARY TO PROVIDE ALL INFORMATION.