Chapter 19

LIQUIDATION, FAILURE, BANKRUPTCY, AND REORGANIZATION

Not every company justifies the confidence its original investors placed in it. A free enterprise system is one of profit and loss. There is no guarantee that all capital will earn the “normal” rate of return. In a world of change, where sure knowledge of the future is lacking and decisions are made under conditions of more or less uncertainty, the operation of any business is a calculated risk. The data in Figure 1 depicts the failure rate per 10,000 firms in the United States during the 1930-1998 period.\(^1\) The reader obviously notes the high level of business failures during the Great Depression. The reader may be surprised by the high level of failures during the 1980s, given the excellent stock market performance. Failures have risen substantially during the past forty years, and were very high during the 1990-1992 period. As noted in Chapter 5 there was a deterioration in the Altman Z score, the bankruptcy prediction model, during the 1963-2003 period as a result of falling profit margins and sales efficiency. The large debt issuance of the 1975-2003 period, combined with high interest rates during several years of the period, was no doubt an important factor in the rising failure rate. Buell and Schwartz (1979) modeled the failure rate in the U.S. during the 1950-1978 period as a function of the total debt to total assets ratio and the variation about the time trend of the level of employment. Buell and Schwartz reported the increases in the debt ratio were (highly) statistically associated with the failure rate whereas the failure rate is negatively associated with employment. An economic downturn is associated with decreasing cash flows and lower operating cash flows of firms. Under an increase in financial leverage, a favorable turn in economic events can bring a firm high earnings; however, on the other hand, a recession in demand or a miscalculation of costs may entail substantial losses.

The broad question explored in this chapter concerns the course of action open to the various classes of investors (suppliers of funds to the firm) in the event the company does not perform at a minimum level.

The Bankruptcy Reform Act of 1978 provides the formal procedures for the resolution of claims against the firm. The bankruptcy act provides for liquidation (Chapter 7) or reorganization (Chapter 11). A bankruptcy filing may be voluntary or involuntary.
1. VOLUNTARY LIQUIDATION

Liquidation is the sale of the operating assets of a firm and their conversion into cash or other liquid assets. In most cases the cash is returned to the investors according to their legal priorities. The trustee appointed by the court shuts down the firm and sells its assets. Assets are distributed by the absolute priority rule (APR), where the court establishes the seniority, or hierarchy, of claims. No junior claims are paid until senior claims are fully paid.

Liquidations may be voluntary or involuntary. If it cannot properly meet its obligations, an involuntary liquidation may be forced upon the company by its creditors. Involuntary liquidation is one of the remedies in bankruptcy, whereas a voluntary liquidation is undertaken as a decision of the management passed upon by the shareholders. Whether voluntary or involuntary, liquidation is recommended whenever the capitalized value of the reasonably projected cash flow of the firm, i.e. its value as a “going concern,” is below the appraised liquidation value of the company’s assets. In the case of voluntary liquidation, funds may be obtained from the sale of the assets could be used to buy market stock or bonds (in which case the liquidated firm will turn into an investment company), or an entirely different type of business may be purchased. A partial liquidation means that some portion of the claims against the company are paid off and the other investors remain with the scaled-down firm.

Figure 1. U.S. Failure Rate, 1920-1998