

Corporate Bankruptcy

What happens when a public company files for protection under the federal bankruptcy laws? Who protects the interests of investors? Do the old securities have any value when, and if, the company is reorganized? We hope this information answers these and other frequently asked questions about the lengthy and sometimes uncertain bankruptcy process.

What Happens to the Company?

Federal bankruptcy laws govern how companies go out of business or recover from crippling debt. A bankrupt company, the "debtor," might use **Chapter 11** of the Bankruptcy Code to "reorganize" its business and try to become profitable again. Management continues to run the day-to-day business operations but all significant business decisions must be approved by a bankruptcy court.

Under **Chapter 7**, the company stops all operations and goes completely out of business. A trustee is appointed to "liquidate" (sell) the company's assets and the money is used to pay off the debt, which may include debts to creditors and investors.

The investors who take the least risk are paid first. For example, secured creditors take less risk because the credit that they extend is usually backed by collateral, such as a mortgage or other assets of the company. They know they will get paid first if the company declares bankruptcy.

Bondholders have a greater potential for recovering their losses than stockholders, because bonds represent the debt of the company and the company has agreed to pay bondholders interest and to return their principal. Stockholders own the company, and take greater risk. They could make more money if the company does well, but they could lose money if the company does poorly. The owners are last in line to be repaid if the company fails. Bankruptcy laws determine the order of payment.

What Will Happen to My Stock or Bond?

A company's securities may continue to trade even after the company has filed for bankruptcy under Chapter 11. In most instances, companies that file under Chapter 11 of the Bankruptcy Code are generally unable to meet the listing standards to continue to trade on Nasdaq or the New York Stock Exchange. However, even when a company is delisted from one of these major stock exchanges, their shares may continue to trade on either the OTCBB or the Pink Sheets. There is no federal law that prohibits trading of securities of companies in bankruptcy.

Note: Investors should be cautious when buying common stock of companies in Chapter 11 bankruptcy. It is extremely risky and is likely to lead to financial loss. Although a company may emerge from bankruptcy as a viable entity, generally, the creditors and the bondholders become the new owners of the shares. **In most instances, the company's plan of reorganization will cancel the existing equity shares.** This happens in bankruptcy cases because secured and unsecured

creditors are paid from the company's assets before common stockholders. And in situations where shareholders do participate in the plan, their shares are usually subject to substantial dilution.

If the company does come out of bankruptcy, there may be two different types of common stock, with different ticker symbols, trading for the same company. One is the old common stock (the stock that was on the market when the company went into bankruptcy), and the second is the new common stock that the company issued as part of its reorganization plan. If the old common stock is traded on the OTCBB or on the Pink Sheets, it will have a five-letter ticker symbol that ends in "Q," indicating that the stock was involved with bankruptcy proceedings. The ticker symbol for the new common stock will not end in "Q". Sometimes the new stock may not have been issued by the company, although it has been authorized. In that situation, the stock is said to be trading "when issued," which is shorthand for "when, as, and if issued." The ticker symbol of stock that is trading "when issued" will end with a "V". Once the company actually issues the newly authorized stock, the "V" will no longer appear at the end of the ticker symbol. Be sure you know which shares you are purchasing, because the old shares that were issued before the company filed for bankruptcy may be worthless if the company has emerged from bankruptcy and has issued new common stock.

During bankruptcy, bondholders will stop receiving interest and principal payments, and stockholders will stop receiving dividends. If you are a bondholder, you may receive new stock in exchange for your bonds, new bonds, or a combination of stock and bonds. If you are a stockholder, the trustee may ask you to send back your old stock in exchange for new shares in the reorganized company. The new shares may be fewer in number and may be worth less than your old shares. The reorganization plan will spell out your rights as an investor, and what you can expect to receive, if anything, from the company.

The bankruptcy court may determine that stockholders don't get anything because the debtor is insolvent. (A debtor's solvency is determined by the difference between the value of its assets and its liabilities.) If the company's liabilities are greater than its assets, your stock may be worthless. Contact your local Internal Revenue Service (IRS) office or call 1-800-829-1040 for information about how to report worthless securities as a loss on your income tax return. If you don't know whether your stock has value, and you can't find a stock or bond price in the newspaper, ask your broker or the company for information.

Why Would a Company Choose Chapter 11?

Most publicly-held companies will file under Chapter 11 rather than Chapter 7 because they can still run their business and control the bankruptcy process. Chapter 11 provides a process for rehabilitating the company's faltering business. Sometimes the company successfully works out a plan to return to profitability; sometimes, in the end, it liquidates. Under a Chapter 11 reorganization, a company usually keeps doing business and its stock and bonds may continue to trade in our securities markets. Since they still trade, the company must continue to file SEC reports with information about significant developments. For example, when a company declares bankruptcy, or has other significant corporate changes, they must report it within 15 days on the SEC's Form 8-K

How Does Chapter 11 Work?

The U.S. Trustee, the bankruptcy arm of the Justice Department, will appoint one or more committees to represent the interests of creditors and stockholders in working with the company to develop a plan of reorganization to get out of debt. The plan must be accepted by the creditors, bondholders, and stockholders, and confirmed by the court. However, even if creditors or stockholders vote to reject the plan, the court can disregard the vote and still confirm the plan if it finds that the plan treats creditors and stockholders fairly. Once the plan is confirmed, another more detailed report must be filed with the SEC on Form 8-K. This report must contain a summary of the plan, but sometimes a copy of the complete plan is attached.

Who Develops the Reorganization Plan for the Company?

Committees of creditors and stockholders negotiate a plan with the company to relieve the company from repaying part of its debt so that the company can try to get back on its feet.

- One committee that must be formed is called the "official committee of unsecured creditors." They represent all unsecured creditors, including bondholders. The "indenture trustee," often a bank hired by the company when it originally issued a bond, may sit on the committee.
- An additional official committee may sometimes be appointed to represent stockholders.
- The U.S. Trustee may appoint another committee to represent a distinct class of creditors, such as secured creditors, employees or subordinated bondholders.

After the committees work with the company to develop a plan, the bankruptcy court must find that it legally complies with the Bankruptcy Code before the plan can be implemented. This process is known as plan confirmation and is usually completed in a few months.

Steps in Development of the Plan:

- The debtor company develops a plan with committees.
- Company prepares a disclosure statement and reorganization plan and files it with the court.
- SEC reviews the disclosure statement to be sure it's complete.
- Creditors (and sometimes the stockholders) vote on the plan.
- Court confirms the plan, and
- Company carries out the plan by distributing the securities or payments called for by the plan.

What is the Role of the U.S. Securities & Exchange Commission in Chapter 11 Bankruptcies?

Generally, the SEC's role is limited. The SEC will:

- review the disclosure document to determine if the company is telling investors and creditors the important information they need to know; and
- ensure that stockholders are represented by an official committee, if appropriate.

Although the SEC does not negotiate the economic terms of reorganization plans, we may take a position on important legal issues that will affect the rights of public investors in other bankruptcy cases as well. For example, the SEC may step in if we believe that the company's officers and directors are using the bankruptcy laws to shield themselves from lawsuits for securities fraud.

How Will I Know What's Going On?

Sometimes, you may first learn about a bankruptcy in the news. If you hold stock or bonds in street name with a broker, your broker should forward information from the company to you. If you hold a stock or bond in your own name, you should receive information directly from the company.

You may be asked to vote on the plan of reorganization, although you may not get the full value of your investment back. In fact, sometimes stockholders don't get anything back, and they don't get to vote on the plan.

Before you vote, you should receive from the company:

- a copy of the reorganization plan or a summary;
- a court approved disclosure statement which includes information to help you make an informed judgment about the plan;
- a ballot to vote on the plan; and
- notice of the date, if any, for a hearing on the court's confirmation of the plan, including the deadline for filing objections.

Even when stockholders do not vote, they should get a summary of the disclosure statement, and a notice on how to file an objection to the plan.

Stockholders may also receive other notices unrelated to the plan of reorganization, such as a notice of a hearing on the proposed sale of the debtor's assets, or notice of a hearing if the company converts to a Chapter 7 bankruptcy.

What is Chapter 7 Bankruptcy?

Some companies are so far in debt or have other problems so serious that they can't continue their business operations. They are likely to "liquidate" and file under Chapter 7. Their assets are sold for cash by a court appointed trustee. Administrative and legal expenses are paid first, and the remainder goes to creditors. Secured creditors will have their collateral returned to them. If the value of the collateral is not sufficient to repay them in full, they will be grouped with other unsecured creditors for the rest of their claim. Bondholders, and other unsecured creditors, will be notified of the Chapter 7, and should file a claim in case there's money left for them to receive a payment.

Stockholders do not have to be notified of the Chapter 7 case because they generally don't receive anything in return for their investment. But, in the unlikely event that creditors are paid in full, stockholders will be notified and given an opportunity to file claims.

Does My Stock or Bond Have Any Value?

Usually, the stock of a Chapter 7 company is worthless and you have lost the money you invested.

If you hold a bond, you might only receive a fraction of its face value. It will depend on the amount of assets available for distribution and where your debt ranks in the priority list on the first page. If your bond is secured by collateral, your payment will depend in large part on the value of the collateral.

Where Can I Find More Information?

The Company. - Contact the investor relations department in the company's home office. They can give you more information on the bankruptcy proceeding, including the name, address, and phone number of the court handling the bankruptcy.

Your Broker. - If you can't find information in the newspaper or the library, or you haven't received any correspondence from the company, call the person who sold you the investment.

The SEC. - Companies file regular reports with the SEC in a computer database known as EDGAR. For example, a company declaring bankruptcy will file a form 8-K that tells where the case is pending and which chapter of bankruptcy was filed. You can [access EDGAR](http://www.sec.gov) through your computer at: <http://www.sec.gov> If you don't have access to a computer, your public library may have a computer you can use. You can also request a copy of Form 8-K, or any other reports that the company files with the SEC, from the SEC's Public Reference Room, 100 F Street NE, Washington, D.C. 20549-0102, (202) 551-8090 (e-mail: publicinfo@sec.gov). Or, you can visit the Public Reference Room in Washington. You might also be able to get copies of SEC filings from your full-service stockbroker, or the company itself.

Bankruptcy Court. - If the company is in Chapter 7, and has not filed reports with the SEC, or you need more information, the bankruptcy court itself is another source. This court is usually located where the company has its main place of business or where the company is incorporated. (There is at least one bankruptcy court in each state and the District of Columbia.) Once you know a company's main place of business or state of incorporation, you can obtain the address and phone number of the bankruptcy court for that region by visiting the website of the [Administrative Office of the United States Courts](http://www.uscourts.gov) or by calling (202) 502-1900. Court addresses and phone numbers are also listed in the publication, The American Bench, which you can find at your local library. In addition, you'll find links to U.S. Bankruptcy Court websites at <http://www.uscourts.gov/bankruptcycourts.html>.

U.S. Trustee at the Department of Justice. - The U.S. Trustee has broad administrative responsibilities in bankruptcy cases. Check the [U.S. Trustee's website](http://www.uscourts.gov),

your local telephone book, or the public library for the field office closest to you, and contact them for information on the status of the bankruptcy.

A Securities or Bankruptcy Attorney. - You may want to talk to an attorney, especially if you believe that the debtor defrauded you and you want to know your legal options. If you suspect fraud, you should also [report it to the SEC](#) or your [state securities regulator](#).

For a more detailed discussion of different types of bankruptcy, please read [Bankruptcy Basics](#), which the Bankruptcy Division of the Administrative Office of the United States Courts produced to assist the public in understanding bankruptcy.

<http://www.sec.gov/investor/pubs/bankrupt.htm>