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Special Report

Learning to Love Bankruptcy

- The Bonds of Companies in Chapter 11 Can Be a Great Buy
- Expectations of a Bond's Status Influences Its Price

Learning to Love Bankruptcy

The Bonds of Companies in Chapter 11 Can Be a Great Buy

Expectations of a Bond's Status Influences Its Price

The word *bankruptcy* conjures images of shuttered doors, out-of-work employees, and failed, no-longer-operating businesses. But that's not really what it means. Bankruptcy often means a new beginning for a business. And for bondholders, the process can mean the opportunity to invest when things are distressed – realizing huge gains as companies and their bonds emerge from a troubled state.

For distressed-debt investors, knowing about bankruptcy is critical. In this report, we will tell you how bankruptcy works, and then explain why it's important for bondholders to know the ins and outs of the process.

There are two reasons why knowledge of the U.S. Bankruptcy Code can help distressed investors:

1. For companies that have already filed for bankruptcy, knowledge of the bankruptcy codes will tell you how much return you as a bondholder have a right to expect.
2. For companies that *haven't* filed for bankruptcy, an understanding of potential bankruptcy risk will help you, as a potential bondholder, properly value the investment.

How Bankruptcy Works

Porter & Co. Distressed Investing looks at companies that have operating problems and have borrowed a lot of money. The bonds of companies like these trade at high yields because their price has fallen below – sometimes far below – their maturity value of $1,000 per bond. This market discount exists because the market believes that there is some risk of the company "defaulting" – or not making interest or principal payment within 30 days of when they are due.

When a business defaults, each creditor is entitled to go after the borrower's assets. A typical distressed company has borrowed money from banks, issued bonds to investors, and bought goods and services from its vendors. If all these parties try to collect on the money they are owed and there isn't enough to go around, the legal wrangling can quickly turn into an ugly fight.

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It's a Bankruptcy *Process*...

That's why we have the bankruptcy *process*. It's a series of steps with a set of rules on how to divvy up the value of a business that can't pay its lenders on time and in full – and may be worth less than the total it owes its lenders.

This is a short summary of the bankruptcy process and a few important rules – with as little bankruptcy jargon as possible. At the end, we provide a glossary of bankruptcy terms for anyone looking for greater detail.

A company that can't pay its debts as they come due – or one that has become clearly worth less than its debt – so that it will eventually hit the wall, can "seek protection" under Chapter 11 of the U.S. Bankruptcy Code.

The process starts when a company petitions the court to let it file for bankruptcy. If the judge permits the company to file for bankruptcy (as is usually the case) he issues an **automatic stay** – a court order that prevents ***any*** investors from enforcing their loans until there is a plan of reorganization providing for ***all*** creditors to be paid.

There are two goals of the **stay**.

1. To give the company breathing room to turn around its business. Bankruptcy provides companies favorable treatment for getting out of unfavorable contracts – like leases (for example offices, stores, or equipment) and in some cases labor agreements.
2. To give its creditors time to negotiate who will get what at the end of the process when the company *emerges* from bankruptcy.

How Much Do Investors Get?

The outcome for bond investors when the company emerges could be anything from 0% to 100% of the money owed – sometimes even including interest payments it missed. The *payout* depends on a few key pieces of information:

- the total amount the company owes
- where each lender fits in the pre-set pecking order
- the value of the business.

The Total Amount Owed

The total amount owed is the sum of everything the company borrowed from banks or by selling bonds, plus the amount it owes its suppliers. For instance, a portion of a company's balance sheet might look like this:

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Banks, Bonds, and Creditors	
Owed to bank lenders	$400 million
Owed to bondholders	$300 million
Owed to "trade creditors"	$150 million
Total amount owed	$850 million

Let's also assume the company has also issued $50 million face value of preferred stock and 25 million shares of common stock.

The Pecking Order of Creditors

Every lender to a company knows where it stands on the pecking order if the company stops making payments on its obligations. They agree to this ranking system when the loan is made or the bonds are issued.

There are two basic types of creditors:

1. *Secured creditors* lend a company money in exchange for a promise to repay the loan or bonds *and* a claim on specific assets that are pledged. The "loan security" might be real estate – offices or factories, as examples – or anything else the lender can negotiate to be collateral. The idea is that the lender could sell the collateral if the company stops paying on the loan. Bank loans are usually secured loans. Bonds are sometimes secured, sometimes not.
2. *Unsecured creditors* lend money to the business in exchange for a promise to repay the loan or bonds. Unsecured loans and bonds as well as money owed to suppliers fall into this category.

One of the most important concepts in bankruptcy is the **Absolute Priority Rule**. According to absolute priority, when the company comes out of bankruptcy its secured lenders – $400 million in our example – get paid first. Unsecured lenders – $300 million owed to bondholders and $150 million owed to trade creditors in our

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example – get paid second. Any preferred stock gets paid third. The value left over after paying the preferred stock – if any – goes to the company's stockholders.

Priority Ladder – Order of Payment	
Secured claims	These include bonds and loans that are backed by liens on specified assets of the company, rather than being simply general claims on the company.
Administrative and priority claims	These include the professional fees (such as payments to lawyers) incurred by the company and the creditor committees, post-petition expenses such as leases and sales agreements on not-yet-delivered goods, and the company's ongoing business costs.
General unsecured claims	Unsecured obligations, typically labeled "debentures" or "notes," fall into this category, unless they're also labeled "subordinated." Most convertible bonds are in this category.
Subordinated claims	These are usually called "subordinated debentures."
Preferred equity	This group will recover a higher percentage than a holder of the common stock.
Common equity	Common stockholders rank at the bottom in terms of recovery of claims in bankruptcy. This often means that there's no recovery at all for these claimants.

The Business Value

During the bankruptcy process, lawyers – there are *many* lawyers involved – represent banks, bondholders, and trade creditors. They usually end up fighting with each other – and often with the company – to maximize their client's slice of what the company will be worth when it emerges from bankruptcy.

Valuing a business is both an art and a science. There is no one right answer, a range of reasonable estimates and some less-reasonable ones as well.

Lenders and stockholders very often fight over how much a business is worth. The shareholders at the bottom of the pile always want to stretch the company's value to justify some payout when the company comes out of bankruptcy. The lenders at the top want to shrink that same value because they want to maximize the percentage of the company's value they receive.

Let's go back to our earlier example. Let's look at what each tier of creditors would receive based on three business valuations – $600 million, $800 million, and $1 billion. The total amount owed of $850 million comes from bank lenders, bondholders, and creditors such as vendors. The bank lenders are first in line, likely to get 100% of their $400 million at all three valuation options. The $450 million in unsecured debt (bondholders and creditors) are next, but not as likely to get full

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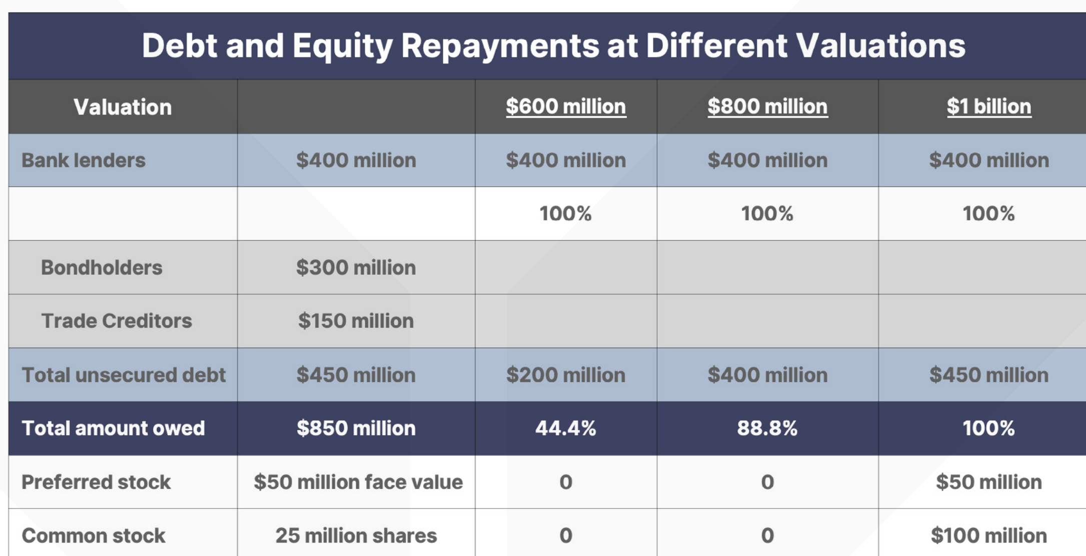
payment at the lower valuations. Shareholders are last in line – and see some of their money back at the highest valuation. Also note what each class's incentives are:



Debt and Equity Repayments at Different Valuations				
Valuation		**$600 million**	**$800 million**	**$1 billion**
Bank lenders	**$400 million**	**$400 million**	**$400 million**	**$400 million**
		100%	**100%**	**100%**
Bondholders	**$300 million**			
Trade Creditors	**$150 million**			
Total unsecured debt	**$450 million**	**$200 million**	**$400 million**	**$450 million**
Total amount owed	**$850 million**	**44.4%**	**88.8%**	**100%**
Preferred stock	**$50 million face value**	**0**	**0**	**$50 million**
Common stock	**25 million shares**	**0**	**0**	**$100 million**

The main points to notice in this example are:

- The secured debt is paid in full in all cases. At the low end of the range these lenders would receive 67% of the value of the company (think of it as 67% of the shares). At the high end of the range the secured debt would receive 40% of the value of the shares. For the secured lenders, the lowest valuation gives them the best outcome. If the company improves, they would have a larger share of the upside.
- There is $450 million of unsecured debt – $300 million in bonds and $150 million owed to suppliers. Since the $400 million in secured debt is paid first, the unsecured debt needs a business valuation of at least $850 million to be paid in full. They only receive 44.4% of its claim at the $600 million valuation, 88.8% of its claim at $800 million.
- Preferred stock only has value after all the debt is paid off. The business needs to be worth more than $850 million for the preferred stock to receive anything. The preferred stock will receive full payment if the business is worth $900 million.
- Common stock only has value after the debt and preferred stock is paid off. In this example, the company would need to be worth more than $900 million. In the case where the business is worth $600 million and $800 million, common stock gets no payout. If the business is worth $1 billion, the common stock is worth $100 million. (In this example that would be $4 per share.)

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The End Game

During the bankruptcy process the company can use favorable provisions of the Bankruptcy Code to get out of expensive leases and contracts at a relatively small cost. (It can hold on to all favorable leases or contracts.) At the same time, the company prepares a set of projections that the lenders use to frame their own negotiations. Using these projections as a starting point, the lenders and the company will agree to:

- An approximate date for the company to emerge from bankruptcy and no longer be under court supervision.
- What the company's new balance sheet will look like – based on an agreed-upon value for the business. For example, if a business is worth $750 million, it might have $250 million to $350 million in new bonds or bank debt and $400 million to $500 million in new common stock.
- How the new bonds and stock get whacked up among the different classes that have claims against the company.

This information forms the core of the company's plan of reorganization – the document the company submits for approval by the bankruptcy court. If the court accepts the plan, the company then sends it out to each bondholder and stockholder. They get to vote on whether to approve or reject the plan of reorganization.

To approve a plan, each class – secured lenders would be a class, unsecured credits would be a separate class, and so forth – must meet *both* of these two tests:

1. More than 50% of the members of that class must accept the plan.
2. Those 50% or more of members must together own at least 66.7% of the value of the securities in that class.

For instance, if there are 1,000 secured creditors that all together are owed $600 million, the plan needs to be approved by at least 501 (1000/2 plus 1) creditors who own at least $400 million ($400/$600 = 2/3) of the bonds in that class.

Once the plan is approved, the court sets a date for the company to emerge from bankruptcy. That date is usually a few months after the plan is approved – to leave time to issue and distribute the emerging company's stock and bonds. After the company emerges from bankruptcy, it operates as any other company would. Its "old" stock and bonds are canceled, and its "new" stock and bonds trade normally.

Now that you know how bankruptcy proceedings work, let's talk about the two main reasons you, as a bondholder, should care about this.

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1. Why Bankruptcy Matters for Bondholders

For companies that have already filed for bankruptcy, knowledge of the bankruptcy codes will tell you how much return you as a bondholder have a right to expect.

Some of the best distressed-debt opportunities arise in bonds of companies that have already filed for bankruptcy – which, as a reminder, does not mean the companies are going out of business. They are entering formal legal proceedings to restructure their debt load. While the company attempts to straighten out its financial affairs and is paying no interest to its creditors, its bonds can be bought at knockdown prices. There may be huge uncertainty about how much of their original investment – $1,000 face value per bond – the holders will recover in the end.

The prices may be so low that an astute investor who buys at that point will reap a gain of 100% or more when the company emerges from bankruptcy. So to get a solid grasp of our analysis of this kind of opportunity, it's important to be able to follow the arguments we present with the U.S. Bankruptcy Code as our framework.

How Default Relates To Bankruptcy

Defaults occur in two different forms. A **money default** occurs when a company fails to make a scheduled interest or principal payment on time and in full. Bankruptcy doesn't automatically follow. The company and its creditors may arrange an out-of-court settlement in order to avoid the legal expense and diversion of management attention that a bankruptcy filing entails. The settlement might enable the company to get through its financial tight spot by reducing the bond's coupon rate or extending its maturity (the date on which the bond's principal comes due).

Another type of default is a **technical default** – it occurs when a company violates a covenant, which is a contractual requirement to (for example) maintain a specified ratio of earnings to interest costs. Maintenance covenants of this sort are typically found in bank loans, rather than in bonds. Most often, bank lenders react to a technical default by tightening their control over the company.

For example, banks might require management to submit financial reports on a more frequent basis. Accordingly, technical defaults alone don't usually lead to a bankruptcy filing.

If lenders think the company has bigger problems, they may not want the company to use its cash to pay lenders that are lower in the pecking order. In cases like this, they might decide that they're better off forcing the company into bankruptcy sooner rather than later. That way, there will be more cash left – and they'll probably recover more than if the company's inevitable failure is delayed. This course of action ultimately helps bondholders – by forcing the company into bankruptcy there is an orderly process for recovering at least some of the bonds' value.

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Liquidation Versus Reorganization

Filing a bankruptcy petition doesn't automatically mean that the company goes out of business – with its assets sold off and the proceeds going to its creditors. That outcome is known as a **liquidation** and is handled using Chapter 7 of the Bankruptcy Code. U.S. bankruptcy law encourages an alternative solution – reorganization, as addressed by Chapter 11 of the Bankruptcy Code.

The idea behind Chapter 11 is that it's better for the lenders, employees, and customers (and for the economy) if the bankrupt company continues operating while reducing its debt burden to a manageable level. The company's financial distress is relieved through a bankruptcy plan in which the company's creditors are paid a portion of what they're owed through some combination of cash, new bonds, and stock in the ongoing company.

Note that a company must show either that it is insolvent (worth less than its debt) or so short on cash it will not be able to make interest and principal payments when due. That is to say, a company in solid financial health can't use the bankruptcy process as a ploy to shortchange its creditors – which for bondholders is a great safeguard of their investment in the company's bonds.

How the Reorganization Process Works

Court Supervision

A Chapter 11 reorganization proceeding is supervised by a judge of a federal bankruptcy court. The management of the bankrupt company usually runs it as the **debtor in possession**, which we describe in more detail below. As safeguards against possible abuse by the company's management, committees representing the creditors participate in the process. The judge also has the power to appoint a bankruptcy trustee or examiner if management shows any signs of misbehavior.

The Plan of Reorganization

In Chapter 11 the goal is to come up with a plan of reorganization and then get it approved by lenders and then by the court. The plan sets the terms for distribution of the reorganized company's value to the various classes of claimants listed above in the priority ladder. Because a Chapter 11 process is a reorganization and not a liquidation, the company's assets are not sold for cash. Instead, claims are paid in part or sometimes fully with bonds or stock (or both) in the reorganized company.

Creditor committees are set up, based on the categories of claimants shown in the priority ladder above. These committees negotiate the terms of the plan on behalf of the members of their respective claimant classes. Much of the negotiation involves the determination of the reorganized company's total asset value. The

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lower-ranking classes will hire experts to argue for a high valuation, so that there will be enough imputed value to justify at least a partial recovery for their claims. The highest-ranking committees' experts, on the other hand, will argue for a low valuation so that most or all of the reorganized companies' assets will be reserved for settling their client's claims.

Managing Disagreements

To obtain approval, the plan must receive "Yes" votes from more than 50% of the claimants in each class of creditors represented by a committee. In addition, within each such class approval must be obtained from holders representing at least two-thirds of the dollar amount of claims.

Under these arrangements, the members of a low-ranking class try to block approval of the plan. They can vote "No" – holding out for a larger recovery of their claims than they would deserve under the absolute-priority rule. As a safeguard against this sort of strategic obstruction, the judge has the ability to impose a **cramdown**. This occurs when the judge determines that the proposed plan awards low-ranking holders at least as much as they'd receive if the company were closed and its assets liquidated. In a cramdown, the judge approves the plan despite the holdouts' objections.

That's how the process plays out for companies that have entered bankruptcy – and what it means for holders of that company's bonds. Now let's look at how the prospect of bankruptcy – whether real or perceived by the market – affects the performance of a company's bonds.

2. For Companies Not in Bankruptcy Proceedings

For companies that have not filed for bankruptcy, understanding the potential of such proceedings will help bondholders value the investment.

Unless a bond is an obligation of the U.S. Treasury, the market assumes it has some probability of default, however small. According to historical data compiled by rating agency Moody's over the period 1983-2022, even a AAA credit has a 0.1% (one-in-1,000) chance of failing on its debt within five years.

That kind of number isn't going to keep bondholders awake at night. But let's look at the other end of the rating spectrum. A company rated Caa has a 30% chance of defaulting within five years, according to Moody's. Over a 10-year holding period that rises to a 47% probability, meaning a Caa company is almost as likely to default as not over the next decade.

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If you buy at the right time and at the right price, you can get paid extremely well to take that kind of risk. For example, the average bond in the ICE BofA U.S. Distressed High Yield Index produced a 91% one-year return, beginning from the midpoint of the 2020 recession. (Bonds rated Caa by Moody's or the equivalent CCC by Standard & Poor's accounted for half of all distressed issues at that time.)

How Bankruptcy Risk Affects Valuation

So how does the possibility of bankruptcy affect the price of a bond, even if it's not in bankruptcy? Here's a simple illustration.

Suppose Company XYZ has debt coming due three years from now that has the potential of not being paid in full. Analysts see a substantial risk that the company will be unable to obtain new financing at that point – without which it won't be able to repay the principal on the maturing debt. That would cause the company to default on its bond issue and file for bankruptcy.

Now let's suppose the market sets the probability of XYZ's bond defaulting at that crisis point, three years out, at one-in-two, or 50%. As of publication date, January 23, 2024, that bond's risk premium – defined as the yield difference (or "**spread**") between the bond and default-risk-free Treasury bonds – would have been about 22 percentage points – or the rate on a three-year government bond plus an extra 22% each year. That's the current median spread for bonds rated in the rock-bottom Ca-C rating categories by Moody's. Companies rated Ca-C have a 53% chance of defaulting within three years, according to Moody's.

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But what if the collective wisdom of investors is wrong? Let's suppose skilled analysts' more realistic estimate of the company's chances of going belly-up – to use a favorite term of distressed investors – when the big debt bill comes due is only 20% rather than 50%. In that case, Moody's would give the bond a higher rating of Caa. Currently, the spread would be around seven percentage points. Companies in that category have a one-in-five, or 20%, chance of defaulting within three years.

In this situation we'd alert readers that in our judgment, the XYZ bond's yield is higher than it ought to be – meaning that its price is lower than it ought to be. Pouncing on the opportunity isn't without risk, but you're getting paid more than fairly for the risk. Over time, buying distressed bonds that are trading cheaper than their actual risk justifies will pay off richly, even though some of them will default, despite that being judged the less probable outcome. Depending on the circumstances, we may recommend hanging tough or taking the loss at that point and moving on.

The key point is that the possibility that the issuer will "hit the fan" – another bit of distressed-investing lingo – makes a difference in valuing its bonds. Getting to the right value requires knowing what's likely to happen to the various creditors who will vie to pick up the scraps.

In short, *bankruptcy* should not be a scary word for bondholders. In fact, it can mean opportunity. The bond price of a company in Chapter 11 proceedings may become so low that an astute investor who buys them at the right time could reap a gain of 100% or more when the company emerges from bankruptcy. And for most bonds that are not in bankruptcy, the market assumes there is some probability of default – and this probability, whether small or large, will affect the price of the bond. Astute investors can benefit by having that knowledge.

*At **Porter & Co. Distressed Investing**, we may sometimes recommend bonds of companies that we believe are likely to be heading toward bankruptcy – we do this because we anticipate that there is great value to be realized in the future. This guide explains the bankruptcy process and highlights how we go about assessing the risk.*

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Glossary of Terms

Automatic Stay

To give the company breathing room to restructure its finances, an *automatic stay* bars creditors from collecting on debts, or enforcing liens. Lessors may not terminate or alter leases. The company, on the other hand, can reject (unilaterally terminate its obligations under) a lease.

DIP Financing

To obtain necessary funds during the reorganization in bankruptcy, the company can obtain debtor-in-possession (DIP) financing. Lenders are generally eager to provide funding in this form, as it has priority over

pre-bankruptcy secured loans in the eventual settlement of claims. It typically offers attractive interest rates and fees, as well as numerous protective covenants. Further adding to its appeal to lenders, DIP financing has a very low historical default rate.

Ability to Abrogate Collective Bargaining Agreements

Collective bargaining agreements with unionized workers can be modified – with court approval – if that's deemed necessary to keep the company viable.

Preferential Payments

Foreseeing a bankruptcy filing, a company's management might think about paying a favored creditor in full before filing. That would violate the Bankruptcy Code's aim of equal distribution, since other creditors in the same class could consequently wind up with less than a full recovery. To protect the non-favored creditors against such unfair treatment, the Code provides for a 90-day lookback (one year for transfers to corporate insiders). The court can order the recovery of payments made during the lookback period.

Fraudulent Transfers

A lookback period of two years is established for payments deemed to be fraudulent transfers. There are two types. Actual fraud pertains to transfers made with the intent to defraud creditors. In a constructive fraud, no intention to defraud creditors was involved, but a payment was made in exchange for something of less than equivalent value.

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