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Costs of Reorganizing Under Chapter 11: Some Evidence from the 1980s

AUG 1, 1999 (TMA HQ CHICAGO) — For those in the turnaround business dedicated to the resolution of corporate distress at the least cost and as quickly as possible, a "yardstick" of costs of reorganization in bankruptcy may shed light in a general way on professional practice. Anecdotal views abound, but there is little in the way of systematic evidence.

The Sample Set

The findings reported in this article are drawn from an empirical study [1] with an emphasis focusing on the considerable body of data available through the SEC and other sources about the reorganization costs incurred by publicly traded companies in the ten years following passage of the Bankruptcy Reform Act of 1978.

For findings to serve as any sort of meaningful benchmark, it is important to understand the characteristics of the sample analyzed. The Bankruptcy Reform Act of 1978 was intended to promote consensual reorganization of firms in financial distress—a conceptual shift from the emphasis under the earlier Chandler Act on an orderly allocation of payments to claimants. In the first decade following passage of the Act (October 1979 to September 1988) 163,515 firms filed for Chapter 11 reorganization. Only 5 percent resulted in confirmed plans of reorganization. Only 838 firms (less than 0.5 percent of the total) were publicly traded. According to the SEC, the classification 'publicly traded firm' includes every issuer of listed securities engaged in interstate commerce, or in a business affecting interstate commerce; with total assets of \$1 million and a class of equity security held of record by 750 or more persons as of the end of any fiscal year. Of the 838 companies, 101 geographically diverse firms were identified which successfully emerged from Chapter 11. The sample includes 56 NYSE and AMEX listed firms and 45 OTC firms.

Information about these companies was obtained from standard disclosure reports (8K, 10Q and 10Ks) required by the SEC, from the Dow Jones News Retrieval System (DJNS) and from Compustat data where available. While these firms all disclose in their 10K filings all costs incurred throughout their stay in bankruptcy, the exact manner in which they do this varies. Some itemize the direct costs of bankruptcy as an income item expense. Others accrue the costs associated with bankruptcy as a balance sheet item. Still others include the fees associated with processing the reorganization with general administrative expenses and then fully disclose an itemization of these costs. Unfortunately, similarly rich data are typically not available about non-publicly traded companies, and the data are also weak on costs in cases that fail to end up successfully reorganized.

Whereas public corporations represent a small proportion of Chapter 11 filings, the

account for a disproportionate amount of asset totals. According to the Statistical Analysis and Reports Division [SARD] of the Administrative Office of the United States Courts (Statistical Analysis of Chapter 11, October 1989), the combined assets measured in book value of all entities filing for Chapter 11 protection exceed \$200 billion for the period. Given the number of filings reported, the average book value is \$1.2 million. The combined assets of public companies with available accounting information equal \$99.3 billion for an average value of \$182.5 million. In the aggregate, public companies are, on average, 152 times the average size of firms filing for Chapter 11 protection. These firms accounted for more than 50 percent of the assets in reorganization. They were also five times more likely than the non-publicly traded firms to successfully reorganize.

Findings

From the sample of 101 successfully reorganized publicly traded firms, McMillan, Nachtmann, and Phillips-Patrick find that the direct costs of bankruptcy averaged 8.5 percent of the book value of the firm on exiting Chapter 11. The median value was 8.1 percent. If measured on the basis of entering book value, the direct costs averaged 10.1 percent. These costs were incurred over 1.87 years, the average time these firms spent in reorganization.

Direct costs are the nominal sum of all legal, accounting and management consulting fees paid by the firm during its time in bankruptcy court. Costs identified by firms in 10K, 10K and 10Q reports as costs associated with reorganization ranged from a minimum of \$30,000 to a maximum of \$3,065,000,000, with a mean of \$36.1 million and a median of \$1.08 million.

The 1.87 years (682 days) on average in bankruptcy compares to a median of 1.57 years (574 days), with a minimum of 37 days and a maximum of 7.98 years.

The mean book value of assets of firms in the sample set at the end of the fiscal year prior to bankruptcy filing (according to 10Ks) was \$562.9 million, with a median of \$100 million and a min./max. range of \$100,000 to \$34.94 billion. At the time of emergence from Chapter 11, mean asset value was \$367.73 million, with a median of \$17.76 million. The low was \$90,000 and the high was \$26.3 billion.

The data suggest that book value of assets may provide an ex ante proxy for a debtor's ability to pay for services rendered by workout specialists. The costs of a Chapter 11 reorganization are levied against the assets of the firm and since reorganization services are costly, a positive association might be expected between the size of the asset pool and the successful development of a confirmed plan. Summary data support this conjecture. The SARD summarizes a study of 2,395 Chapter 11 cases with confirmed plans of reorganization. The average asset size was \$5.3 million and the ratio of assets for firms with confirmed plans to the average Chapter 11 firm was 4.42 to 1.

What determines direct costs?

Firm size, capital structure, and time in bankruptcy explain approximately 50 percent of the variability in the level of direct costs across firms in cross sectional regression. Corporate reorganization through Chapter 11 is obviously a complex process. The study evaluates the operating as well as the financial characteristics of the firm but does not

unilaterally dictate an outcome. A successful reorganization plan is a function of management's success or the success of one of the creditor groups in engineering a consensus of opinion. This consensus is expected to include:

- the valuation of assets;
- the relationship between the pre-petition book valuation of assets and the rest-asset structure;
- and the composition of the financial structure of the emerging firm.

The mean value of corporate assets upon leaving Chapter 11 is approximately 60 percent of the average book value of assets upon entering, while the median is about 50 percent. The reduction in asset value can be viewed as the average error in book value as approximations of market value or of the extent of asset sales during reorganization. There were many companies that emerged from Chapter 11 with more assets than when they entered. This evidence suggests that firms in the sample may appeal to the protection of the court to achieve strategic objectives. This is most notable in the case of large bankruptcies in the period that were driven by products liability considerations, such as Johns Manville, A.H. Robins, and UNR Industries.

The nature of the firm's assets is also a determinant of direct costs. All first digit SIC codes are represented in the sample and 40 two-digit codes. There is a concentration of bankruptcies in two industrial groups represented by SIC codes 13 and 35. SIC code 13 is oil and gas extraction (there were 15 cases). SIC code 35 is non-electrical machinery and equipment (10 cases). All firms in SIC code 35 are represented by the three digit code 357: Office and Computing Machines. No other industry group is represented by more than four events.

Finally, as suggested above, particular courts can contribute to the cost of processing a bankruptcy. Efficient judges with knowledge of bankruptcy procedure, the nature of the business and an understanding of financial instruments can contribute positively to a reduction in deadweight costs. Firms in our sample were processed by 35 federal circuit courts. Interestingly, the Southern District of New York heard 19 of the cases. No other district was responsible for more than six cases, and some had as few as one. There was once a general perception that the Southern District of New York was the most experienced court at processing bankruptcy petitions, but for the 1978-1988 period this does not appear to have translated into less costly reorganizations of bankrupt firms.

Further Directions for Research

Useful directions for further research are obvious. Analysis of the same sample set in the second decade (1988-1998) since passage of the Bankruptcy Reform Act would provide a valuable comparison, especially in light of developments such as the pre-pack, section 363 sales and the increasing dominance of the Delaware court as the venue of choice for large cases. And what determines the way bankruptcy expenses are dealt with in accounting statements?

Much more difficult to design, but probably of relevance to the greatest number of members, would be analysis of reorganization costs for non-public companies. Perhaps a confidential or anonymous survey of TMA members could be undertaken to gather

information about costs in a wide variety of actual cases.

[1] This study was conducted by Robert Nachtmann of the University of Pittsburg Henry McMillan of Transamerica Corporation and Fred Phillips-Patrick of the Department of Treasury.

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