**Unit 4: bankruptcy liquidation and reorganization**

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**4.0 Aims and Objectives**

After completing this unit successfully, students should be able to: -

* + differentiate between bankruptcy liquidation and bankruptcy reorganization
  + understand accounting for bankruptcy liquidation
  + understand accounting for bankruptcy reorganization
  + understand the roles of accountants, court, creditors and trustee in bankruptcy liquidation.

**4.1 introduction**

Changes in business environment are common. If they are not properly managed, they may cause business failures. More specifically, the causes of business failures include poor management, excessive debt, and inadequate accounting. These result in the inability of firms to pay their liabilities when they become due. This would bring about bankruptcy.

This chapter is concerned with bankruptcy liquidation and reorganization.

**4.2 insolvency Vs Bankruptcy**

The term insolvent and bankrupt are often used interchangeably. Such usage is technically incorrect. Insolvent refers to the financial condition of a person or business enterprise whereby the sum of debts is greater than all of the fair value of its property. On the other hand, bankrupt refers to a legal state.

**4.3 bankruptcy liquidation**

Bankruptcy liquidation refers to the process that involves the realization (sale) of the assets of an individual or a business enterprise and the distribution of the cash proceeds to the creditors of the individual or enterprise. There are four classes of creditors in bankruptcy liquidation. There are:

* 1. **Fully secured creditors**. They are entitled to obtain satisfaction of all or part of their claims from the assets pledged as collateral.
  2. **Partially secured creditors**.
  3. **Unsecured creditors with priority**. The claims of these creditors are satisfied in full from proceeds of realization of the debtor’s noncollateralized assets.
  4. **Unsecured creditors without priority**. This class of creditors receive cash from proceeds available from the realization of the debtor’s assets.

**4.3.1 Debtor’s petition (voluntary petition)**

According to bankruptcy code, any person may file a petition in a court for voluntary liquidation. The debtor’s bankruptcy petition must be accompanied by supporting exhibits of the debts and property of the petitioner. The debts are classified into three. There are:

1. Creditors having priority
2. Creditors holding security
3. Creditors having unsecured claims without priority

The property of the debtor is reported into three categories

1. Real property
2. Personal property
3. Property claimed as exempt

N.B

1. Valuation of property are at market or current fair value
2. A statement of financial affairs also accompanies the debtor’s bankruptcy petition.

**4.3.2 Creditors’ petition (Involuntary petition)**

If the debtor owes unpaid amounts to 12 or more unsecured creditors who are not employees, relatives, stockholders, or other insiders, three or more of the creditors who have unsecured claims totaling $10,000 or more may file in a federal bankruptcy court a creditors’ petition for bankruptcy. The creditors’ petition is also called involuntary petition. If the number of unsecured creditors is less than 10, one or more creditors having unsecured claims of $10,000 or more may file the petition. The petition of the creditors for bankruptcy may claim anyone of the following:

1. The debtor is not paying debts as they come due
2. The debtor is not paying debts within 120 days prior to the date of the petition

**4.3.3 Unsecured creditors with priority**

Unsecured creditors may be classified into unsecured creditors with priority and unsecured creditors without priority. If adequate cash is not available for all unsecured creditors, the available cash needs to be paid in full to the unsecured creditors with priority. Debts which are found in this category include:

* + Administrative costs
  + Claims arising in the course of the debtors business or financial affairs after the commencement of a creditors’ bankruptcy proceeding but before the appointment of a trustee or order for relief.
  + Claims for wages, salaries, and commissions (including vacation, severance, and sick leave pay not in excess of $4000 per claimant) earned within 90 days before the date of filing petition for bankruptcy or cessation of the debtor’s business.
  + Claims for contributions to employee benefit plans arising within 180 days before the date of filing the petition for bankruptcy cessation of the debtor’s business.
  + Claims by producers of grain against a grain storage facility or by fisherman against a fish storage or processing facility not in excess of $4000 per claimant
  + Claims for cash deposited for goods/ services for the personal, family, or household use of the depositor, not in excess of $1800 per claimant.
  + Claims for alimony, maintenance, or support of a spouse, former spouse or child of the debtor, under a separation agreement, divorce decree, or court order.
  + Claims or government entities for various taxes or duties, subject to varying time limitations.

Note that settlement of the above debts would be in the order specified.

**4.3.4 Property claimed as exempt**

Certain property of a bankruptcy petitioner is not included in the debtors’ estate. These include:

* + Residential property exemptions provided by homestead laws.
  + Exemptions for life insurance policies payable on death to the spouse or a relative of the debtor.

**4.3.5 Role of court in liquidation**

All aspects of the bankruptcy proceedings are dealt with by the Federal Bankruptcy Court (USA) with respect to a debtor’s and creditor’s petition for bankruptcy liquidation. The roles of the court include:

1. Dismiss the debtor’s or creditor’s bankruptcy petition or to grant an order for relief. An order for relief is given for the filling of a debtor’s petition in bankruptcy. The court also gives order for relief in a creditor’s petition after a hearing at which the debtor may attempt to refuse the creditors’ allegations that the debtor was not pay debtors as they came due. Thus, the creditors’ petition may be dismissed or order for relief be given by the court.

Any suits that are pending against a debtor for whom a debtor’s or creditors’ bankruptcy petition is filed are stayed until order for relief or dismissal of the petition after order for relief, such suits are further stayed until the question of the debtor’s discharge is determined by the court.

1. The court appoints an interim trustee to serve permanently or until the trustee is elected by the creditors. This is done after the court granted the order for relief.
2. The court calls a meeting of the creditors after the order for relief within 10 to 30 days.

**4.3.6 Role of creditors**

As indicated above, within a period of 10 to 30 days after order for relief, the court calls a meeting of the creditors. One of the responsibility of the creditors is to appoint a trustee to manage the debtor’s estate. A majority vote is required for actions by creditors in appointing the trustee.

**4.3.7 Role of the Trustee**

The trustee may be appointed by the court or elected by the creditors. The trustee is required to assume the custody of the non-exempt property of the debtor. The principal duties of the trustee are:

1. Continue to operate the debtor’s business (if directed by court)
2. Realize the free assets of the debtor’s estate
3. Pay cash to unsecured creditors
4. Keep accounting records to enable the filing of a final report with the court
5. Invalidate a preference

Preference is defined as the transfer of cash or property to an “outsider” creditor for an existing debt made while the debtor was insolvent and within 90 days of filing of the bankruptcy petition. This is the case if the transfer caused the creditor to receive more cash or property than would be received in the bankruptcy liquidation. In this case, the trustee may recover from the creditor the cash or property constituting the reference and include it in the debtor’s estate.

**4.3.8 Discharge of Debtor**

Discharge refers to the release of the debtor from all unliquidated debts. It is the court that determines the debtor’s discharge. The role of the trustee is to liquidate the debtor’s property and pay the necessary claims.

After all properties have been liquidated, all secured and priority creditor claims have been paid, and all remaining cash has been paid to unsecured, nonprority creditors.

Discharge of the debtor does not include:

* 1. taxes payable by the debtor
  2. debts resulting from the debtor’s obtaining money or property under false representations, or willful conversion of the property of others.
  3. debts not scheduled by the debtor in support of the bankruptcy petition.
  4. debts arising from embezzlement or other fraudulent acts by the debtor acting in a fiduciary capacity.
  5. amounts payable for alimony, maintenance, or child support
  6. debts for willful and malicious injuries to the persons or property of others
  7. Debts for fines, penalties, or forfeitures payable to government entities, other than for tax penalties
  8. Debts for educational loans made, insured or guaranteed by governmental entities, or by nonprofit universities or colleges.

Note that a debtor will not be discharge if:

! The debtor for commits any crimes, misstatements, or other malicious acts that are in connection with the court proceedings.

!! The current bankruptcy petition was fined within six years of a previous bankruptcy discharge to the same debtor.

* + 1. **Role of Accountant in Bankruptcy Liquidation**

The role of the accountant in liquidation proceedings is concerned with proper reporting of the financial condition of the debtor and adequate accounting and reporting for the trustee for the debtor. There are

***1. The statement of affairs.***

The statement of Affairs is prepared to present the financial condition of the debtor enterprise. The statement is prepared on the assumption of quitting concern. This is due to the fact that a business enterprise that enters bankruptcy liquidation proceedings is a quitting concern and not a going concern. As a result, the balance sheet is not appropriate for an enterprise in liquidation. Thus, Statement of Affairs is the financial statement designed for a business enterprise entering liquidation.

The purpose of the Statement of Affairs is to display the assets and liabilities of the debtor enterprise from the point of liquidation. The assets of the debtor enterprise are valued at current fair values and the carrying values are presented on a memorandum basis. Besides, assets and liabilities are classified according to the rankings and priorities. They are not prevented according to the current classification used in the traditional balance sheet.

***2. Statement of Realization and liquidation***

Liquidation involves realization of the assets of the debtor’s estate. Statement of Realization and liquidation is based on the assumed activities of the trustee for the estate of the bankrupt firm. This statement is accompanied by the statement of cash receipts and cash payments.

**Check your progress 4.1**

1. The term insolvent and bankruptcy are technically used inter changeably. (True / False)
2. If the sum of debts exceeds the fair value of all of its property, the firm is said to be

(Insolvent / Bankrupt)

1. Bankruptcy liquidation involves:

a). Realization of bankrupt firm’s assets

* 1. Distribution of cash proceeds to the creditors
  2. Permit the firm to alive
  3. A and B.

1. Which class of creditors are entitled to obtain satisfaction of all or part of their claims from
   * 1. Partially secured creditors
     2. Fully secured creditors
     3. Unsecured creditors with out priority
     4. Unsecured creditors with priority
2. The class of creditors who are entitled to receive cash from proceeds available from the realization of the debtor’s assets are:
   * 1. Unsecured creditors with out priority
     2. Unsecured creditors with priority
     3. Fully secured creditors
     4. Partially secured creditors
3. The class of creditors who are satisfied in full from proceeds of realization of the debtors non collateralized assets are:
   * + 1. Unsecured creditors with out priority
       2. Unsecured creditors with priority
       3. Partially secured creditors
       4. Fully secured creditors
4. In voluntary petition, petition is filed by:
   * 1. Creditors c) family of debtor
     2. Debtors d) government
5. In bankruptcy liquidation, the property of the debtor is classified into:
6. Personal property c) property claimed as exempt
7. Real property d) all of the above
8. In involuntary petition, petition is filed by:
9. Debtors c) government
10. Creditors d) spouse of the debtor
11. If adequate cash is not available for all unsecured creditors, the available cash needs to be paid in full to the unsecured creditor without priority. (True/False)
12. In bankruptcy liquidation, which of the following is not property claimed as exempt?
13. Residential property c) business policies
14. Life insurance policies d) a and b
15. Which of the following is the role of court in liquidation?
16. Appoint the trustee
17. Call the meetings of the creditors
18. Dismiss the debtor’s or creditor’s petition for bankruptcy
19. Grant an order for relief
20. All of the above
21. The major role of the creditors in bankruptcy liquidation is to appoint a trustee who will manage the estate of the debtor. (True/False)
22. Which of the following is not the duty of the trustee in bankruptcy liquidation
23. Keep accounting records
24. Pay cash to unsecured creditors
25. Operate the debtor’s business
26. All of the above are the duties of the trustee
27. The release of the debtors from all unliquidated debts is referred to as:
28. Recharge c) discharge
29. Discredit d) uncharge
30. The debtor’s discharge is determined by:
31. The creditor c) the trustee
32. The debtor d) the court e) all of the above
33. Which of the following is the role of accountant in bankruptcy liquidation?
34. Adequate accounting and reporting for the trustee
35. Prepare statement of affairs
36. Prepare statement of realization and liquidation
37. Reporting of the financial condition of the creditor
38. All except d
39. In bankruptcy liquidation, the statement of affairs is:
40. Prepared to present the financial condition of the debtor enterprise
41. Prepared on the assumption of going concern
42. Designed for a business enterprise entering liquidation
43. Used to display the assets and liabilities of the debtor enterprise

from the point of liquidation

1. All except b
2. The statement of realization and liquidation is based on the assumed activities of the court for the estate of the bankrupt firm. (True/False)

**4.4 bankruptcy reorganization**

When a business becomes insolvent, it does not have enough cash to meet its interest and principal payments. Then the decision must be made whether to dissolve the firm through liquidation or to permit it to reorganize and thus stay alive. The decision to force a firm to liquidate versus permit it to reorganize depends on whether the value of the reorganized firm is likely to be greater than the value of the firm’s assets if they are sold off piecemeal. The issue of liquidation was discussed earlier.

In a reorganization, a committee of unsecured creditors is appointed by the court to negotiate with the management on the terms of a potential reorganization., the reorganization may call for a restructuring of the firm’s debt. The restructuring of debts involve:

* 1. Reduce interests rate
  2. Lengthen the term to maturity
  3. Exchange some debts for equity

The purpose of restructuring is to reduce the financial charges to a level that the firm’s cash flows can support.

In addition to committee, the court may appoint trustee to oversee the reorganization.

**4.4.1 Appointment of trustee or examiner**

The management or owners of the business enterprises may continue to operate the enterprise as debtor in possession. Alternatively, the court may appoint a trustee to manage the enterprise.

The purposes of appointing the trustee are

* 1. To reduce fraud, dishonesty, incompetence or gross management by current owners or managers
  2. To protect the interest of the creditors or stockholders of the enterprise.

Where the reorganization involves the trustee, examiner may be appointed to investigate possible fraud or mismanagement by the current managers or owners of the enterprise.

The powers and duties of the trustee include:

1. Prepare and file a list of creditors in court. The list includes class of creditors and their claims and lest of stockholder of each class.
2. Investigate the acts, conduct, property, liabilities, and business operations on the enterprise. The trustee indicates the desirability of continuing operations.
3. Report to the bankruptcy judge any facts ascertained as to fraud against or mismanagement of the debtor enterprise.
   * 1. **Plan of reorganization**

The management or trustee is required to submit the plan of the organization to the bankruptcy court. The same plan may also be given to the creditors and stockholders of the enterprise. The purpose of submitting the plan of reorganization is for confirmation by the bankrutpcy court. Before the plan of reorganization is confirmed by the court, the plan must be accepted by the following parties:

* 1. Majority of the creditors, whose claims must account for two thirds of the total liabilities.
  2. Stockholder owning at least two thirds of the outstanding capital stuck of each class.

If one or more classes of stockholders or creditors has accepted a plan, the bankruptcy court may conform if the plan is fair and equitable to the nonacceptors. If the plan of reorganization is confirmed by the bankruptcy court, it becomes binding on the debtor enterprise, on all creditors and owners of the enterprise, and on any other enterprise issuing securities or acquiring property user the plan.

* + 1. **Accounting for a Reorganization**

Accounting for reorganization involves journal entries for the following adjustments:

* + 1. Carrying amounts of assets
    2. Reduction of par or sated value of capital stock
    3. Extensions of due dates and revisions of interest rates of notes payable
    4. Exchanges of debt securities for equity securities (debt securities include notes payable, bond, etc. Equity securities primarily include common stock and preferred stock).
    5. The elimination of a retained earnings deficit.

The reorganized enterprise is essentially a new enterprise whose assets and liabilities should be valued at current fair values and whose shareholders’ equity consists only of paid in capital.

To illustrate accounting for reorganization, suppose Topcon Company has the following assets. Liabilities, owners equity before bankruptcy petition by the debtors.

Topcon Company

Balance sheet

December 31,2003.

Assets:

Current Assets: Br. 95,000

Faded assets 180,000

Total cossets 275,000

Liabilities and stockholders’ Equity:

Liabilities:

Current liabilities:

Notes payable (due December 31,2004) 40,000

Notes payable (due September 30,2004) 50,000

Trade Accounts payable 20,000

Salaries and wages payable 10,000

Employee Income taxes payable 25,000

Total current liabilities 145,000

Bonds payable 100,000

Total liabilities 245,000

Stockholders’ Equity:

Common stock, Br.100 par, 600 shares authorized issued

and outstanding 60,000

Deficit (30,000)

Total liabilities and stockholders’ equity 275,000

Stockholders and all unsecured creditors have approved the plan of reorganization and the bankruptcy court has conformed it.

The plan of reorganization is described below

1. Deposit Br 40,000 with escrow agent, to cover liabilities with priority and costs of reorganization proceedings (Br. 7000). Salaries and wages and employee income taxes payable are liabilities with priorities.
2. Amend articles of incorporation to provide for 10,000 shares of authorized common stock of Br.1 par. The new common stock is to be exchanged on a share for share basis for the 600 shares of outstanding Br.100 par common stock.
3. Extend due date of unsecured notes payable to suppliers totaling Br. 50,000 for three years until December 31,2007. Increase the interest rate on te notes from the stated rate of 10% to 12%.
4. Exchange 2000 shares of new Br.1 par common stock (at current fair value of Br.20 a share) for unsecured notes payable to suppliers totaling Br. 40,000.
5. Pay suppliers 60 cents per dollar of trade accounts payable owed.

The journal entries to record the reorganization are shown below:

1) (a) To record deposit of cash with escrow agent

Cash with escrow Agent 40,000

Cash 40,000

(b) To record escrow agent’s payment of liabilities with priority

Salaries and wages payable 10,000

Employee income taxes payable 25,000

Cash with Escrow Agent 35,000

(c) To record payment for cost of bankruptcy proceedings

Costs of Bankruptcy proceedings 7000

Cash with escrow agent 7000

(2) To record issuance of 600 shares of Br. 1 common stock in exchange for 600 shares of Br. 100 par common stock

Common stock, Br. 100 par 60,000

Common stock, Br. 1 par 600

Paid in capital in excess of par 59400

(3) To record extension of due dates on Notes Payable

10% Notes Payable to suppliers, due date Dec. 31, 2004 50,000

12% Notes Payable to suppliers, due date Dec. 31, 2007 50,000

(4) To record exchange of 2000 shares of Br. 1 par common stock for Notes Payable

Notes payable to suppliers 40,000

Common stock, Br. 1 par 2000

Paid in capital in excess of par 38,000

(5) To record payment of Br. 0.60 per Birr of Accounts payable to suppliers

Trade accounts payable 20,000

Cash (20,000 x 0.60) 12000

Gain from discharge of indebtedness in Bankruptcy 8000

Assuming that fresh start reporting is appropriate for the company under consideration after the plan of organization has been carried out. The following journal entry is made to eliminate retained earnings deficit.

Paid in capital in excess of par 29000

Gain from discharge of indebtedness in Bankruptcy 8000

Costs of Bankruptcy proceedings 7000

Retained earnings 30,000

**4.4.4 Disclosure of reorganization**

Notes to the financial statements are used to present the complex issues that are involved in bankruptcy reorganization. The disclosure should include for the period in which the plan of reorganization was carried out.

### Check your progress 4-2

1. A bankrupt firm is reorganized if its value is likely to be greater than the value of the firm’s assets when sold off piecemeal. (True/False)

2. The reorganization of bankrupt firm may involve:

1. Lengthening the term to maturity
2. Exchanging some debts for equity
3. Reducing interest rates
4. All of the above
5. b and c

3. In bankruptcy reorganization, the former management, by no means, can continue to operate the enterprise. (True/False)

4. The court may appoint the trustee in reorganization

1. To reduce fraud and dishonesty
2. To protect the interest of the creditors
3. To protect the interest of shareholders of the enterprise
4. a and b
5. All of the above

5. The duties and responsibilities of the trustee in reorganization are:

1. Investigate the acts of business operations of bankruptcy firm
2. Report any facts related to fraud to debtors
3. Prepare and file a list of creditors in court
4. Evaluate the desirability of continuing the operation of bankruptcy firm
5. All except b

6. Which of the following party is not concerned with the plan of reorganization?

1. Majority of the creditors
2. Stockholders owning at least one-third of capital
3. Court
4. a and c
5. All of the above

7. A plan of reorganization which is confirmed by the bankruptcy court becomes binding on the

1. Debtor enterprise d) party issuing securities
2. All creditors e) all of the above
3. Stockholders

8. In bankruptcy reorganization, the deposit of cash with escrow agent is debited to:

1. Accounts receivable
2. Paid-in capital in excess of par
3. Cash with escrow agent
4. Cash
5. Cost of bankruptcy proceedings

9. Consider the following transactions for BCD company plan of reorganization.

1. Amended articles of incorporation to provide for 100,000 shares of authorized common stock, Br. 5 par, to be exchanged on a share-for share basis for 50,000 shares of outstanding no-par, no stated value common stock with a carrying amount of Br. 600,000.
2. Exchange 10,000 shares of the new Br. 5 par common stock for trade accounts payable totaling Br. 70,000.
3. Paid 80 cents per Birr for full settlement of other trade accounts payable totaling Br. 60,000.

**Required:** Prepare journal entries for BCD Company for the foregoing transactions.

**4.5 summary**

The failed business may be liquidated or reorganized. In the case of bankruptcy liquidation non-cash assets are sold and the claims of the various parties be satisfied, usually beginning with creditors. The quest for liquidation may be initiated b y the debtors or creditors. The court, creditors, trustee and accountants are among the major parties involved in liquidation.

On the other hand, a firm in failure state may be reorganized if the value of the reorganized firm is likely to be greater than the value of the firm’s assets if they are sold off piecemeal.

# 4.6 Answers to check your progress exercises

## Check your progress 4-1

1. False 8. D 15. C

2. Insolvent 9. B 16. D

3. D 10. False 17. E

4. B 11. D 18. E

5. A 12. E 19. False

6. A 13. True

7. B 14. D

## Check your progress 4-2

1. True 6. B

2. D 7. E

3. False 8. C

4. E

5. E

9.

a) Common stock, Br. 5 par 250,000

Paid-in capital in excess of par 350,000

Common stock 600,000

b) Trade accounts payable 70,000

Common stock, B r.5 par 50,000

Paid-in capital in excess of par 20,000

c) Trade accounts payable 60,000

Cash (60,000 x 0.80) 48000

Gain from exchange of indebtedness in bankruptcy 12000