

## FRESH-START REPORTING FOR ENTITIES EMERGING FROM CHAPTER 11 REORGANIZATION

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### INTRODUCTION

The Federal Bankruptcy Code is contained in Title 11 of the United States Code and provides for five basic types of bankruptcy cases described in chapters 7, 9, 11, 12, and 13. Larger businesses seeking relief from burdensome debt generally file:

1. under chapter 7 to liquidate company assets and terminate operations or
2. under chapter 11 to reorganize and continue operations.

Under certain circumstances, entities emerging from chapter 11 reorganization adopt fresh-start reporting in accordance with Statement of Position No. 90-7 (SOP 90-7) as promulgated by the American Institute of Certified Public Accountants (AICPA). As part of the adoption of fresh-start reporting, the reorganization value of the emerging entity is allocated to the entity's assets. This value allocation is made in a manner consistent with the accounting for business combinations as specified by Statement of Financial Accounting Standards (SFAS) No. 141 issued by the Financial Accounting Standards Board (FASB).

This article will present (1) an overview of chapter 11 reorganization, (2) the conditions under which the adoption of fresh-start reporting is required, (3) the definition of and estimation of reorganization value, and (4) the reporting of assets and liabilities on the reorganized balance sheet.

### CHAPTER 11 REORGANIZATION

Although (1) individuals are not precluded from filing under chapter 11, (2) sole proprietorships and partnerships may file under chapter 11, and (3) chapter 11 may be used for liquidation, this article will focus on corporate reorganizations. A company seeking relief from burdensome debt, with the intent of reorganizing and continuing operations, may file a voluntary bankruptcy petition under chapter 11. It is also possible for creditors, in certain situations, to file an involuntary petition.

Once a petition is filed, an automatic stay of creditor actions (e.g., foreclosures, repossessions, collection activities)

goes into effect for any pre-petition debt or claim. In some cases, a secured creditor may be granted relief from the stay under the adequate protection provision based, in part, on the estimated current—and future—value of the collateral.

Typically, the debtor (now referred to as the “debtor in possession”) maintains possession and control of the company's assets during the reorganization, though a trustee is appointed in a small percentage of cases. If a trustee is not appointed, the debtor in possession has an exclusive right to file a plan of reorganization during the first 120 days of the case, unless the time frame is amended by the Bankruptcy Court (the “Court”).

Generally, the reorganization plan must then be accepted by each impaired class of (1) creditors' claims and (2) stockholders' interests within 180 days after the filing of a voluntary petition—or else another party may file a plan. Holders of claims that are unimpaired are deemed to have accepted the plan.

Simply defined, a class of claims or interests is impaired (1) if the legal, equitable, or contractual rights of a class are altered by the plan or (2) if the amount to be paid under the plan is less than the full value. A plan is considered accepted by a class of creditors if it is accepted by creditors that hold more than (1) one-half in number and (2) two-thirds in amount of the allowed claims in the class.

A plan is considered accepted by a class of interest if it is accepted by the holders of at least two-thirds in amount of the allowed interests in the class.

The plan of reorganization must, among other things:

1. identify the various classes of claims and interests,
2. report which claims and interests are unimpaired,
3. set forth the proposed treatment of impaired classes of claims and interests, and
4. provide adequate means for the implementation of the plan.

As part of the development of the plan, the reorganization value of the entity that is to emerge from bankruptcy is usually estimated. Reorganization value represents the resources of the entity that are, or will be, available to satisfy:

*“As part of the adoption of fresh-start reporting, the reorganization value of the emerging entity is allocated to the entity's assets.”*

1. the allowed pre-petition claims and interests and
2. the post-petition liabilities.

After (1) all impaired classes of creditors and equity interest holders accept a plan of reorganization and (2) the Court is satisfied that all other requirements have been met, the Court will confirm the plan. There is a "cramdown" provision that allows the Court to confirm a plan even if it has not been accepted by each class of claims or interests. This can only occur if:

1. at least one class of noninsiders holding impaired claims has accepted the plan,
2. the plan does not discriminate unfairly, and
3. the plan is fair and equitable with respect to each impaired class of claims or interests that has not accepted it.

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### CONDITIONS FOR FRESH-START REPORTING

Debtors are required, under SOP 90-7, to adopt fresh-start reporting if two conditions are met. The first condition is that the reorganization value of the assets of the emerging entity (immediately before the date of confirmation of the plan of reorganization) is less than the total of all post-petition liabilities and allowed claims.

The second condition is (1) that the holders of the voting shares immediately before confirmation of the plan receive less than 50 percent of the voting shares of the emerging entity and (2) that this loss of control must not be temporary.

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### REORGANIZATION VALUE

Reorganization value, as defined in SOP 90-7, is the "value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed before reconstitution occurs." This value generally represents the fair value of the entity before consideration of any liabilities and should approximate the amount a willing buyer would pay for the assets of the restructured entity.

The reorganization value is typically determined after negotiations and/or litigation between the debtor-in-possession or

trustee, creditors, and holders of equity interests, each of whom may have a different estimate of reorganization value. The reorganization value is often estimated using a discounted cash flow method, where the expected future cash flows of the reconstituted business are discounted to a present value.

The expected proceeds from assets not required in the emerging business (e.g., non-operating assets to be disposed of and cash in excess of normal operating requirements) are included in the reorganization value.

### THE REORGANIZED BALANCE SHEET

Whether or not fresh-start reporting is adopted, the effect of the plan of reorganization on the entity's balance sheet must be recorded. The reorganized balance sheet must reflect (1) any discharge of debt and (2) any exchanges of stock.

Discharge of debt entries typically record elimination of pre-petition liabilities, payment of debt, forgiveness of debt, and issuance of new debt or stock in exchange for debt. Exchange of stock entries typically record retirement of old stock and issuance of new stock.

As dictated by SOP-97, the balance sheet of a company adopting fresh-start reporting after emerging from chapter 11 reorganization must reflect certain adjustments:

1. The reorganization value of the emerging entity is allocated to the entity's assets in a manner consistent with the accounting for business combinations as specified by SFAS No. 141. In effect, the restructuring of equity ownership is treated much like an acquisition.

The reorganization value is allocated to the entity's assets (other than goodwill) based on their estimated fair values. This may result in asset values being written up or down from historical costs.

An intangible asset, which may or may not have been reported on the balance sheet of the predecessor company, may be reported on the reorganized balance sheet apart from goodwill if:

- a. it arises from contractual or other legal rights or
- b. if it could be separated from the entity and sold, transferred, exchanged, licensed, or rented.

Any portion of the reorganization value that cannot be attributed to specific tangible or intangible assets should be treated as goodwill, though this amount is usually reported as "reorganization value in excess of amounts allocable to identifiable assets."

2. Liabilities, other than deferred taxes, existing at the plan confirmation date are reported on the balance sheet at the present values of the amounts to be paid, discounted using appropriate current interest rates.
3. Deferred taxes are reported in conformity with generally accepted accounting principles (GAAP). Benefits realized from preconfirmation net operating loss carryforwards should first reduce reorganization value in excess of amounts allocable to identifiable assets until exhausted, after which any remaining benefits are reported as a direct addition to paid-in capital.
4. Retained earnings or deficits of the predecessor entity are eliminated from the balance sheet.

SOP 90-7 also states that if, within 12 months after the adoption of fresh start reporting, any changes in accounting principles will be required in the financial statements of the emerging entity, these changes should be adopted at the time fresh-start reporting is adopted.

Notes to the initial financial statements of the emerging entity must disclose:

1. adjustments to the historical carrying values of assets and liabilities,
2. the amount of the debt forgiveness, and
3. information related to the estimation of the reorganization value, such as the methods used and key valuation variables.

It should be noted that fresh-start financial statements are not comparable to preconfirmation financial statements. Therefore, comparative financial statements including reporting periods both before and after the confirmation date should not be presented in annual and other reports.

## SUMMARY

Chapter 11 of the bankruptcy code provides a means for companies seeking relief from burdensome debt to reorganize and continue operations. After a voluntary or involuntary petition is filed, a reorganization plan must be (1) filed, (2) accepted by the impaired classes of claims and interests, and (3) confirmed by the Bankruptcy Court for a company to emerge from chapter 11 reorganization.

The estimation of an entity's reorganization value is usually a key part of any reorganization plan and is necessary to determine if fresh start reporting will be required. Estimation of the reorganization value entails the valuation of the reconstituted business as well as the valuation of any tangible or intangible assets that may be (1) spun-off to generate cash or (2) liquidated as nonessential to the reconstituted business.

When fresh-start reporting is adopted, reorganization value is allocated to the assets in conformity with SFAS No. 141. (See the article by Gregg S. Gaffen in this issue of *Insights* for more information about SFAS No. 141.) This generally necessitates the valuation of both tangible and intangible assets.

A company emerging from chapter 11 reorganization—as well as creditors, equity interest holders, or a trustee—may need to obtain independent valuation opinions related to:

1. reorganization value, including the value of any assets to be spun-off or liquidated,
2. the allocation of the reorganization value to the tangible and intangible assets if fresh-start reporting is adopted, and
3. assets used as collateral.

Although not specifically addressed in this article, valuations are also performed for a number of other purposes during bankruptcy proceedings, including claims determination, asset recovery, liquidation value estimation, solvency determination, and plan confirmation decision-making.

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