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Statements of Financial Affairs and Schedules as a Corporate X-Ray

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About the Author

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The Statement of Financial Affairs and Schedules of Assets and Liabilities (the "statements and schedules") are filed in a chapter 11 act as a corporate x-ray of a troubled company. Although this interior view most often presents itself after the patient becomes critical, much can be learned by looking at a troubled company through the prism of the chapter 11 process. Although it may not necessarily prevent a petition for relief, examining a corporation through the filing requirements can provide a more clear picture as to why filing for chapter 11 may be necessary. The initial statements and schedules, if compiled accurately, aim to illuminate a debtor's shortfalls and point to the potential hit the body of creditors may have to take.


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Prior to this process, it was not unusual for management to underestimate the breadth of a company's debt and contingent obligations since they are often focused on the day-to-day operations and any immediate financial crises. If a corporation does file for relief, the information revealed during the statements-and-schedules gathering process affects the structure of the plan of reorganization, potential financing arrangements and the viability of a newly reorganized company. CEOs and CFOs can benefit by seeing the assets and liabilities in black and white as required by the Bankruptcy Code before an actual filing. Unfortunately, a debtor's accounting and contracts systems are seldom designed for the requirements of a bankruptcy filing, so the burdensome undertaking of the process is not one to be taken lightly, or pushed through at breakneck speed. Obviously, it may not be cost-effective to perform such an exercise simply for the benefit of curiosity, but looking at the requirements of key statement questions and specific schedule sections can be extremely illuminating to management and their counsel. A select group of both statement questions and schedule sections will be highlighted to show how they may shed some light on the underlying health, and thus the future of a troubled company.

Statement of Financial Affairs

In the first two questions of the statements, a debtor is asked to report its income. If a company is healthy and reporting increasing quarterly profits, one would hope that all should be well, but it is known that gross income does not begin to convey the health of a profitable company—or an unprofitable one. This is merely a starting point to which assets can be added and from which liabilities can be deducted. Tallying the year-to-date and past two years income may give the debtor some assurance that chapter 11 is worth considering, but economic spikes and downturns, seasonal cycles (as in retail), and other factors may skew these numbers, for better or worse. Perhaps numbers do not lie, but they do not always tell the whole truth either.

In question three, payments to creditors made within the last 90 days, and insider payments in the last year, things get a little more interesting. Comparing the last three months of money flowing out of the company to question 1 may be apples and oranges because the timeframes differ, but the immediate outflow of money versus what is still owed to the same entities can be telling. Also, in these days of growing shareholder activism and outcries about executive pay, the list of insider payments could prepare you for potential battles with creditors and their representation. Later, under the discussion of Schedules D, E, F and G, one gets a better overall grasp of the outstanding debt versus these numbers of what has been paid in the most recent past. If question three shows that a company has been hemorrhaging cash in a way not seen in previously comparable quarters, this may be something crucial to review.

In question four, a company must report any suits and administrative proceedings, executions, garnishments and attachments. Because of the nature of litigation, it may be difficult—if not impossible—to assign a dollar value to the potential debt owed as a result of any kind of litigation. To see a list of the actions and potential actions that may result in a payout, however, can be extremely eyeopening. Six slip-and-fall cases lurking on the deck somewhere may not pose a great concern, but 600 of them might. Contract disputes, employee suits, etc., can all add burden to an already overburdened bottom line. Additionally, if it becomes necessary to divest the company of property to pay off some debt, knowing which properties have liens against them will prove not only instructive but vital to a reorganizing company.

Question eight requires a listing of losses over the previous year from fire, theft or other casualty. As in question four, seeing what losses a company has incurred in the last year in toto might give a sense of what the next year may hold. If past is prologue, and the losses have been increasing due to circumstances that will continue to exist a year from now or five years from now, this is worth a closer look. A one-time loss from hurricane damage would have different implications than the cost of doing business losses experienced through shoplifting in a retail store, or shipping damages to goods.

Question 17 requires the reporting of environmental issues. We live in a green-conscious world, and while environmental issues have always provided crucial challenges in the past, the current attention paid to global warming and the environmental impacts from manufacturing makes this an even hotter topic. Environmental issues may not only impact a company's bottom line, but also impact its reputation and public relations. No matter what industry a company is in, laws change, administrations change and standards are modified—and never more so than they are today. As with any pending litigation, it may be difficult, if not impossible, to attach a specific cost to an environmental site or pending proceeding. However, seeing the full scope of the potential environmental issues a company may be involved in is crucial to its overall health.

Question 20 requires the listing of the last two inventories, including the dollar amount and basis for inventory. Although shareholders may not like to see a corporation sitting on unsold goods, when it comes to divesting assets to pay off debt, inventories are a crucial piece of the puzzle. More than just getting a sense of what may be moving off the shelves, or what is languishing, getting a sense of the market value of goods may assist in the financing of the reorganization. Inventories are hard assets whose value can change rapidly given changing market conditions, so having a recent and accurate count of your widgets will provide you a firmer ground on which to negotiate.

Schedules of Assets and Liabilities

Schedule A requires a listing of all real property that a debtor has an interest in, including its book value and any secured claims held against such property in the form of liens, etc. How much real estate does your company hold? What are the current market conditions that might make a piece of property a less valuable asset worthy of divesting, or a more valuable asset with collateral value? If a creditor holds a lien against a piece of real property, this could move them to the front of the line in a bankruptcy proceeding and thus affect the overall picture of a plan of reorganization. Similarly, in Schedule B, the listing of personal property, in all its many manifestations, as well as the secured claims against that property, will be something a company's creditors may find very interesting to know.

It is important to remember that all this information becomes public once the statements and schedules are filed, so keep in mind that all of your creditors will have access to it. Having a full grasp of the complete assets a company holds before the creditors do will allow management and its counsel to make the most informed choices for financing a reorganization.

In Schedule D, the creditors whose claims are secured by assets or property are segregated from the rest of the unsecured creditors, which will follow in the subsequent schedules. Seeing the portion of debt that leaves no wiggle room on can be a shocker—but invaluable. If a company is in possession of a copy machine owned by a creditor, the value of that copy machine is crucial to the payment of that debt. Because of the automatic stay granted a debtor in a chapter 11, schedule D will provide the scope of the outstanding issues that can be temporarily arrested while the debtor has time to resolve and reorganize through the creation of a plan. Granting this relief is a crucial benefit of a chapter 11 proceeding. Considering the interests of secured creditors, including those that are unliquidated, may be painful, but one of the most important pieces of a company's reorganization. You cannot avoid death and taxes.

Although Schedule E includes other items such as wages, salaries and commissions, many taxing authorities will fall into the category of priority claims. If a company has various taxes owing, these claimants hold particular rights not as easily dismissed as the general unsecured creditors. Although not secured debt as above, this group of creditors has rights and privileges that cannot be easily dismissed.

In many chapter 11 cases' Schedule Fs, the creditors holding unsecured nonpriority claims may actually contain the bulk of the creditors' debt. Although there may be more potential leeway in this category in terms of developing a plan of reorganization, this group more than likely will have strong representation. The often powerful and voluble creditors' committee will see to it that these creditors get a fair deal in the reorganization. If they do not, they could have the ability to sink a plan by encouraging similar creditors to vote against it. Because of diverse accounting systems, multiple debtors or subsidiary companies, and the wide number of categories of creditors that fall into Schedule F, this may be the most challenging body of information to compile. Vendors, customers, employees and potential litigants may all fall into this group and can have vast and varying kinds of claims upon the debtor.

Seeing how the chips are falling in this group could mean the difference between a successful reorganization and drifting off into a liquidation. Even if the secured creditors have the heft of the dollar amount of debt owed on their side, the unsecured creditors may have the advantage of numbers. Depending on how a plan is written and what is required for its passage, the sheer volume of creditors in Schedule F can be as important a factor as the total dollar amount of the debt.

Contractual obligations can be as wide and diverse as your unsecured claimants. In Schedule G, the section for executory contracts and unexpired leases, creditors may fall into multiple categories, from secured to unsecured, or both. Unexpired stores and real property leases may mean large remaining obligations that can be negotiated with your counsel, while employee contracts, intellectual property agreements and cell phone contracts will be treated differently. Market conditions may once again affect the ability to renegotiate leases, but getting your arms around the complete scope of current contractual obligations may give you better footing for outlining a plan. Leases assumed or rejected under the auspices of a chapter 11 are under crucial deadline restrictions, so the sooner a company has a grasp on the outstanding unexpired obligations, the better.

Conclusion

Laying all of your assets and liabilities out on the table before filing a petition for relief may make you rethink the negotiation process for financing. How much do you need to cover your debts, and under what conditions are you able to pay off the debts owing and dispense with the debt in order to start anew as a reorganized company? Have you covered all of your bases, and not missed any potential creditor who may later come back with a claim because he or she was not properly listed in the statements and schedules? The statements and schedules will need to be reviewed for weaknesses and inaccuracies to prevent any additional burdens surfacing after the schedules are filed.

A balance sheet may not show your debt on your contractual obligation on a 10-year lease, but the chapter 11 Schedule G will. The picture presented may not be a pretty one, but it will reveal the weaknesses and strengths of your company so that it may move forward into a profitable and stable moneymaking venture for all the interest-holders in the company. The filing for relief under chapter 11 is not one to be taken lightly, so looking at the requirements, and preparing yourself and your company by looking at the facts through the prism of chapter 11, will only serve to benefit your company in the long run. ■

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