CHAPTER 30
Financial Distress

Multiple Choice Questions:

I. DEFINITIONS

FINANCIAL DISTRESS

c 1. Financial distress can be best described by which of the following situations in which the firm is forced to take corrective action.
a. Cash payments are delayed to creditors.
b. The market value of the stock declines by 10%.
c. The firm's operating cash flow are insufficient to pay current obligations.
d. Cash distributions are eliminated because the board of directors considers the surplus account to be low.
e. None of the above.

Difficulty level: Easy

INSOLVENCY

c 2. Insolvency can be defined as:
a. not having cash.
b. being illiquid.
c. an inability to pay one's debts.
d. an inability to increase one's debts.
e. the present value of payments being less than assets.

Difficulty level: Easy

STOCK-BASED INSOLVENCY

b 3. Stock-based insolvency is a:
a. income statement measurement.
b. balance sheet measurement.
c. only a book value measurement.
d. Both A and C.
e. Both B and C.

Difficulty level: Easy

FLOW-BASED INSOLVENCY

e 4. Flow-based insolvency is:
a. a balance sheet measurement.
b. a negative equity position.
c. when operating cash flow is insufficient to meet current obligations.
d. inability to pay one’s debts.
e. Both C and D.

Difficulty level: Easy

FINANCIAL RESTRUCTURING

d 5. Financial restructuring can occur as:
   a. a private workout.
   b. an employee buy-out.
   c. a bankruptcy reorganization.
   d. Both A and C.
   e. Both B and C.

Difficulty level: Medium

FINANCIAL DISTRESS

d 6. Financial distress can involve which of the following:
   a. asset restructuring.
   b. financial restructuring.
   c. liquidation.
   d. All of the above.
   e. None of the above.

Difficulty level: Easy

RULES OF ABSOLUTE PRIORITY

c 7. APR, as it relates to financial distress, means the rules of:
   a. absolute profitability.
   b. arbitration priority.
   c. absolute priority.
   d. absolute profitability.
   e. automatic profitability.

Difficulty level: Medium

REORGANIZATION AND LIQUIDATION

c 8. The difference between liquidation and reorganization is:
   a. reorganization terminates all operations of the firm and liquidation only terminates non-profitable operations.
   b. liquidation terminates only profitable operations and reorganization terminates only non-profitable operations.
   c. liquidation terminates all operations and reorganization maintains the option of the firm going concern.
   d. liquidation only deals with current assets and reorganization only consolidates debt.
   e. None of the above.

Difficulty level: Medium

II. CONCEPTS

FINANCIAL DISTRESS

c 9. A firm that has a series of negative earnings, sales declines and workforce reductions is likely head to:

a. a change in management.
b. a merger.
c. financial distress.
d. new financing.
e. None of the above.

Difficulty level: Medium

FINANCIAL DISTRESS

c 10. Some of the various events which typically occur around the period of financial distress for a firm are:

a. continued increase in earnings.
b. steady growth.
c. dividend reductions.
d. Both A and B.
e. Both A and C.

Difficulty level: Easy

REORGANIZATION

b 11. Bankruptcy reorganizations are used by management to:

a. forestall the inevitable liquidation in all cases.
b. provide time to turn the business around.
c. allow the courts time to set up an administrative structure.
d. All of the above.
e. None of the above.

Difficulty level: Easy

FINANCIAL DISTRESS

e 12. A firm has several options available to it in times of financial distress. The firm may:

a. reduce capital and R & D spending.
b. raising new funds by selling securities or major assets.
c. filing for bankruptcy.
d. negotiate with lenders.
e. All of the above statements are true.

Difficulty level: Medium

FINANCIAL DISTRESS

d 13. Most firms in financial distress do not fail and cease to exist. Many firms can actually benefit from distress by:

a. forcing a firm to reevaluate their core operations to retain.
b. realigning their capital structure to reduce interest costs.
c. enter Chapter 11 and liquidate the firm.
d. Both A and B.
e. Both A and C.

Difficulty level: Easy

LIQUIDATION OR REORGANIZATION

c 14. Whether bankruptcy is entered either voluntarily or involuntarily the major difference by Chapter 7 and Chapter 11 is:

a. that liquidation occurs in Chapter 11 but reorganization is the objective under Chapter 7.
b. that there is no priority of claims under Chapter 11.
c. that liquidation occurs in Chapter 7 but reorganization is the objective under chapter 11.
d. no lawyers fees are necessary under Chapter 7.
e. None of the above.

Difficulty level: Easy

STOCK BASED INSOLENCY

d 15. If a firm has a stock based insolvency in both book and market value terms and liquidates:

a. the payoff will not be 100% to all investors.
b. the unsecured creditors are likely to get less than full value.
c. the equityholders typically should receive nothing.
d. All of the above.
e. None of the above.

Difficulty level: Easy

REORGANIZATION

d 16. A firm in financial distress that reorganizes:

a. continues to run the business as a going concern.
b. must have acceptance of the plan by the creditors.
c. may distribute new securities to creditors and shareholders.
d. All of the above.
e. None of the above.

Difficulty level: Easy

LIQUIDATION

b 17. A corporation is adjudged bankrupt under Chapter 7. When do the shareholders receive any payment?

a. After the trustee liquidates the assets and pays the administrative expenses, the shareholders are paid before the creditors.
b. After the trustee liquidates the assets, the administrative expenses and secured creditors are paid, then the unsecured creditors, and, then the shareholders divide any remainder.
c. After the trustee liquidates the assets, the shareholders are paid, next the administrative expenses, the secured creditors, and then the unsecured creditors divide any remainder.
d. After the trustee liquidates the assets the shareholders are paid first because they are the owners of the firm and have the principal stake.
e. None of the above.

Difficulty level: Easy

RULES OF ABSOLUTE PRIORITY

a 18. What is the absolute priority rule of the following claims once a corporation is determined to be bankrupt?

a. administrative expenses, wages claims, government tax claims, debtholder and then equityholder claims
b. administrative expenses, wages claims, government tax claims, equityholder and then debtholder claims
c. wage claims, administrative expenses, debtholder claims, government tax claims and equityholder claims
d. wage claims, administrative expenses, debtholder claims, equityholder claims and government tax claims
e. None of the above.

Difficulty level: Medium

RULES OF ABSOLUTE PRIORITY

d 19. The absolute priority rule:

a. is set to ensure senior claims are paid first.
b. is the priority rule in liquidations.
c. distributes proceeds of secured assets sales to the secured creditors first and the remainder to the unsecured.
d. All of the above.
e. None of the above.

Difficulty level: Easy

REORGANIZATION

d 20. Many corporations choose Chapter 11 bankruptcy proceedings voluntarily because the management can:
- a. take up to 120 days to file a reorganization plan.
- b. continue to run the business.
- c. reorganize if the required fractions of creditors approve of the plan and it is confirmed reorganization takes place.
- d. All of the above.
- e. None of the above.

Difficulty level: Easy

PRIVATE WORKOUTS

c 21. Which of the following statements about private workouts of financial distress is NOT true?
- a. Senior debt is usually replaced with junior debt.
- b. Debt is usually replaced with equity.
- c. Private workouts account for about three quarters of all reorganizations.
- d. Top management are often dismissed or take pay reductions.
- e. None of the above.

Difficulty level: Medium

PRIVATE WORKOUTS

e 22. Successful private workouts are better for firms than formal bankruptcy because:
- a. direct costs are considerably lower in private workouts.
- b. private workout firms can issue new debt senior to all prior debt.
- c. stock price increases are greater for private workouts than for firms emerging from formal bankruptcy.
- d. Both A and B.
- e. Both A and C.

Difficulty level: Medium

FINANCIAL DISTRESS- EQUITY HOLDER PREFERENCES

d 23. Equityholders may prefer a formal bankruptcy filing because:
- a. the firm can issue debtor in possession debt.
- b. they can delay pre-bankruptcy interest payments.
- c. the lack of information about the length and magnitude of the cash flow problem favors equityholders.
- d. All of the above.
- e. None of the above.

Difficulty level: Medium

PREPACKAGED BANKRUPTCIES

c 24. Prepackaged bankruptcies are:
- a. described as a combination of a private workout and a liquidation.
- b. the easiest way to transfer wealth to the shareholders.
- c. described as a combination of a completed private workout and the formal bankruptcy filing.
- d. All of the above.
- e. None of the above.

Difficulty level: Easy

PREPACKAGED BANKRUPTCIES

d 25. In a prepackaged bankruptcy the firm:
- a. and creditors agree to a private reorganization outside formal bankruptcy.
- b. must reach agreement privately with most of the creditors.
- c. will have difficulty when there are thousands of reluctant trade creditors.
- d. All of the above.
- e. None of the above.

Difficulty level: Medium

COSTS OF FINANCIAL DISTRESS

d 26. Financial distress may be more expensive if the:
- a. information about the permanency of shortfall is limited.
- b. firm has many different types of creditors and other investors.
- c. firm has never entered into bankruptcy before.
- d. Both A and B.
- e. Both B and C.

Difficulty level: Medium

PAYOFF TO CREDITORS

d 27. The net payoff to creditors in formal bankruptcy may be low in present value terms because:
- a. the financial structure may be complicated with several groups and types of creditors.
- b. indirect costs of bankruptcy may have been costly in lost revenues and poor maintenance.
- c. administrative costs are high and increase with the complexity and length of time in the formal bankruptcy process.
- d. All of the above.
- e. None of the above.

Difficulty level: Medium

FINANCIAL DISTRESS

e 28. Firms deal with financial distress by:
- a. selling major assets
- b. merging with another firm
- c. issuing new securities
- d. exchanging debt for equity
- e. all of the above.

Difficulty level: Medium

INDIRECT COSTS FO FINANCIAL DISTRESS

d 29. Perhaps equally, if not more damaging, are the indirect costs of financial distress. Some examples of indirect costs are:

a. loss of current customers.
b. loss of business reputation.
c. management consumed in survival and not on a strategic direction.
d. All of the above.
e. Both A and B.

Difficulty level: Easy

CREDIT SCORING MODELS

d 30. Credit scoring models are used by lenders to:

a. determine the borrowers capacity to pay.
b. aid in the prediction of default or bankruptcy.
c. determine the optimal debt equity ratio.
d. Both A and B.
e. Both A and C.

Difficulty level: Medium

ALTMAN Z-SCORE

c 31. Altman develop the Z-score model for publicly traded manufacturing firms. Using financial statement data and multiple discriminant analysis, he found that:

a. in actual use, a Z-score greater than 2.99 meant bankruptcy within one year.
b. in actual use, a Z-score greater than 1.81 implied a 90% chance of bankruptcy within one year.
c. in actual use, a Z-score of less than 1.81 would predict bankruptcy within one year.
d. in actual use, a Z-score less than 2.99 meant non-bankruptcy within one year.
e. None of the above.

Difficulty level: Medium

ALTMAN Z-SCORE

d 32. The key intuition of a Z-score model like Altman's is that:

a. only publicly traded firms can be evaluated.
b. one will be just as well off by guessing on default rates.
c. all corporations will default at least once.
d. financial profiles of bankrupt and non-bankrupt firms are very different one year before bankruptcy.
e. privately traded firms have better financial information which are disclosed to lenders and need not rely on any efficient market notions.

Difficulty level: Medium

LIQUIDATION

b 33. Approximately ____ of all firms going through a Chapter 11 bankruptcy successfully reorganize.

a. 0%
b. 15%
c. 25%
d. 50%
e. 85%

Difficulty level: Medium

ALTMAN Z-SCORE

d 34. Altman's Z-score predicts the:

a. percentage of payout to equityholders in liquidations.
b. percentage of payout to equityholders in reorganization.
c. likelihood of a private workout.
d. likelihood of bankruptcy of a firm within one year.
e. None of the above.

Difficulty level: Medium

III. PROBLEMS

Use the following information for #35-36.

Magic Mobile Homes is to be liquidated. All creditors, both secured and unsecured, are owed $2 million. Administrative costs of liquidation and wages payments are expected to be $500,000. A sale of assets is expected to bring $1.8 million after all costs and taxes. Secured creditors have a mortgage lien for $1,200,000 on the factory which will be liquidated for $900,000 out of the sale proceeds. The corporate tax rate is 34%.

PROCEEDS TO UNSECURED CREDITORS

b 35. How much and what percentage of their claim will the unsecured creditors receive, in total?

a. $ 100,000; 12.50%
b. $ 290,909; 36.36%
c. $ 300,000; 37.50%.
d. $ 600,000; 75.00%
e. Not enough information to answer.

Difficulty level: Challenge

PROCEEDS TO SECURED CREDITORS

c 36. How much and what percentage of their claim will the secured creditors receive, in total?

a. $ 900,000; 75%
b. $ 981,818; 81.82%
c. $1,009,091; 84.1%
d. $1,200,000; 100%
e. Not enough information to answer.

Difficulty level: Challenge

Use the following information for #37-39

The management of Magic Mobile Homes has proposed to reorganize the firm. The proposal is based on a going-concern value of $2 million. The proposed financial structure is $750,000 in new mortgage debt, $250,000 in subordinated debt and $1,000,000 in new equity. All creditors, both secured and unsecured, are owed $2.5 million dollars. Secured creditors have a mortgage lien for $1,500,000 on the factory. The corporate tax rate is 34%.

PROCEEDS TO SECURED CREDITORS

d 37. How much should the secured creditors receive?

a. $1,000,000
b. $1,250,000
c. $1,333,333
d. $1,500,000
e. None of the above.

Difficulty level: Medium

PROCEEDS TO UNSECURED CREDITORS

a 38. How much should the unsecured creditors receive?

a. $ 500,000
b. $ 667,000
c. $ 750,000
d. $1,000,000
e. None of the above.

Difficulty level: Medium

PROCEEDS TO EQUITYHOLDERS

a 39. What will the equityholders receive if they had 5 million shares with a par value of $0.50 each?

a. $0
b. $35,714
c. $583,333
d. $1,000,000
e. None of the above.

Difficulty level: Medium

IV. ESSAYS

40. The Steel Pony Company, a maker of all-terrain recreational vehicles, is having financial difficulties due to high interest payments. The estimated "going concern" value if Steel Pony is $4.0 million. The senior debt claim is on all fixed assets. The balance sheet of the firm is as shown:

Current Assets	$1,100,000	Senior Debt	$2,200,000
Fixed Assets	$2,900,000	Subordinated Debt	$3,200,000
		Stockholders Equity	$-2,000,000

If Steel Pony decides to file for formal bankruptcy and expects to sell the firm for the "going concern" value and pay administrative fees which amounts to 5% of the total going concern value, determine the distribution of the proceeds under the rules of absolute priority.

Administrative expenses .05($4,000,000) = $200,000
Senior (secured) debt = $2,200,000
Subordinate debt = $4,000,000 - $200,000 – $2,200,000 = $1,600,000
Stockholders = $0

41. The Here Today Corporation has applied to your bank for a loan. You have their financial statements and the revised Z-score model of:

Z = 6.56 (Net Working Capital/Total Assets) + 3.26 (Accumulated Retained Earnings/Total Assets) +1.05 (EBIT/Total Assets) + 6.72 (Book Value of Equity/Total Liabilities) where:

Z < 1.23 predicts bankruptcy. A Z score between 1.23 and 2.90 indicates gray area. A Z score greater than 2.90 indicates no bankruptcy. From the financial statements you gathered net working capital of $237,500; accumulated retained earnings of $120,000; book value of equity of $950,000; total assets of $4,750,000; EBIT of $261,250; and total liabilities of $3,800,000. Should the bank lend to Here Today?

Z = 6.56($237,500/$4,750,000) + 3.26($120,000/$4,750,000) + 1.05($261,250/$4,750,000) + 6.72($950,000/$3,800,000)
= 6.56(.05) + 3.26(.0253) + 1.05(.055) + 6.72(.25)
= .328 + .08248 + .05775 + 1.168 = 2.148
Z-score falls in the gray or uncertain area. Caution should be exercised in granting a loan. The debt financing is already high at 80% of assets. Other factors such as age of firm may be important here as net working capital and EBIT are reasonable but accumulated retained earnings are low currently.

Chapter 30

35. Mortgage unsecured = $1,200,000 - $900,000 = $300,000.
Net proceeds remaining = $1,800,000 - $900,000 - $500,000 = $400,000.
Unsecured received = ($800,000/$1,100,000)($400,000) = $290,909.09.
% Received = $209,909.09 / $800,000 = 36.36%.
36. Mortgage unsecured payment = ($300,000/$1,100,000)($400,000) = $109,091
Total mortgage proceeds =$900,000 + $109,091 = $1,009,091
% received = $1,009,091/$1,200,000 = 84.1%.
37. Mortgage lien of $1,500,000
38. $2,000,000 - $1,500,000 = $500,000
39. Receive last in priority. Nothing left, therefore $0