PART ONE

Bankruptcy and Insolvency Environment

1

Accountant's and Financial Advisor's Role in Perspective

§ 1.1 Introduction

Thousands of businesses fail each year in the United States, with periods of marked increases in failures in the 1980s, early 1990s, early 2000s, and 2008 and 2009. The liabilities associated with these failures escalated in the first part of the 1990s, but declined in the late 1990s. In 1998, over 1.4 million bankruptcy petitions were filed. Almost 97 percent of these filings were by consumers, representing the largest number of petitions ever filed in a 12-month period. This increase in filings took place during a period of more than eight straight years of economic growth. In 1998, business filings of 44,367 decreased by 18 percent over the filings in 1997. The number of business filings for the year ending June 30, 1999, was only 39,934. For the first time in five years, the number of total filings declined in 1999. For the year ending June 30, 1999, 1,391,964 petitions were filed. However, the number of filings began to increase again in the early 2000s to around 1.6 million filings. In 2005, the number of filings had increased to over 2 million, due partly to the large number of filings just prior to the effective date of the 2005 amendments to the Bankruptcy Code. In 2006 only 617,660 petitions were filed; however, by 2008 the number of filings increased to over 1.1 million. The number of public filings increased during the first quarter of 2009 to 65 with declared assets of $101 billion.

It was estimated in 1970 that one out of every five Americans had been involved in bankruptcy proceedings as a bankrupt or a creditor, or was acquainted with someone who had become bankrupt.[1] The number involved today is much higher.

On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] (2005 Act). In many ways, the 2005 Act represents the most significant change in the bankruptcy laws since the Bankruptcy Code replaced the Bankruptcy Act in 1979. Although the primary focus of the 2005 Act was on eliminating abuses of the law by consumers, there are provisions in the bill affecting almost all participants in the bankruptcy process—businesses, creditors, landlords, and professionals involved in this field.

[1] David T. Stanley et al., *Bankruptcy: Problems, Process, Reform* (Washington, DC: The Brookings Institution, 1971), p. 1.
[2] Pub. L. No. 109-08, 119 Stat. 23.

There was a desire, driven to a large extent by credit card companies, to make it harder for consumers to walk away from their debts. The motive underlying the 2005 Act is clear from its title, "Bankruptcy Abuse Prevention." Some of the underlying objectives driving the changes in the law were to:

- Use a means test as a method to reduce perceived abuses of the current system by requiring some individuals to either have their petition dismissed or agree to transfer to chapter 11 or 13 and make at least some debt payments with future income.
- Eliminate perceived abuses by consumers in addition to limiting the extent to which individuals can walk away from their debts, by adjusting amounts available for homestead exemptions, for example, and increasing amounts that may be recovered from fraud.
- Reduce the amount of time a business is in bankruptcy as evidenced by, among other things, limits on the time a debtor has to decide whether to assume or reject a lease and on the time a debtor has the exclusive right to develop a plan.
- Provide a source of tax revenue, especially for state and local governments, by changing the tax law to provide fewer tax benefits to individuals and businesses in bankruptcy. With a significant amount of influence from state attorneys general, the drafters of the law were convinced that state and local governments were at a disadvantage when it came to the collection of taxes.
- Provide additional opportunities for creditors of businesses under certain conditions to recover all or a large percent of their prepetition claims by, for example, increasing the reclamation period and providing that goods shipped within 20 days of bankruptcy are administrative expenses.
- Reinstate chapter 12 on a permanent basis and make other changes perceived as necessary to the Bankruptcy Code.
- Provide protection to certain creditors including, for example, those owed amounts for domestic support obligations and secured creditors in chapter 13.

The 2005 Act consists of over 16 different titles. The provisions of the Bankruptcy Code are described throughout this volume, including those changes made by the 2005 Act.

§ 1.2 Scope of Coverage

The scope of these volumes is, deliberately, fairly broad. The various accounting procedures to be followed under each alternative remedy for business failure are analyzed in detail. To provide a complete and realistic description of the environment within which the financial advisor must work, the discussion incorporates the economics and the legal aspects of business liquidations and rehabilitations.

The economics of bankruptcy and insolvency proceedings is most important when considering the various causes of financial difficulties. Once the causes have been ascertained, the most appropriate remedy may then be determined. Economic considerations are also important when analyzing what remedies have proven most successful in particular circumstances.

The legal aspects of bankruptcy permeate the entire work, for the Federal Bankruptcy Code (title 11) establishes the framework within which anyone concerned with insolvency must work. As a result, the Bankruptcy Code is explicitly cited in the descriptions of the petitions, forms, and schedules that must be filed; the alternatives and rights available to all parties involved, including creditors; the requirements of the debtor; and the treatment of the various transactions and property of the debtor, both before and after the proceedings. Bankruptcy and insolvency proceedings cannot be correctly handled unless everyone involved has a thorough understanding of the legal aspects of the case.

Only a small percent of bankruptcy court petitions are filed by businesses (for example, in 2008 approximately 4 percent were business filings); the majority are filed by wage earners. However, it is primarily business bankruptcy and insolvency proceedings that require the services of a financial advisor. The two volumes of this work are therefore directed toward business bankruptcies. Although the emphasis is on incorporated businesses, the material covered is applicable to partnerships and proprietaries because the remedies available are basically the same.

ACCOUNTING SERVICES

§ 1.3 Need for Financial Advisor's Services

The financial advisor provides a range of services that can be effective in helping the debtor overcome financial problems and operate profitably again, which can assist the creditors and their committees in deciding which actions to take. An accountant or financial advisor may become a party to insolvency and bankruptcy proceedings while serving a client who is having financial problems. Before resorting to judicial proceedings, the debtor may attempt to negotiate a moratorium or settlement of its debt with unsecured creditors. Financial advisors may be retained by the debtor and/or creditors' committee to perform accounting and other financial services.

Reorganization of a corporation under chapter 11 of the Bankruptcy Code involves many parties who may need the assistance of financial advisors. First, the debtor, who remains in possession, has the right to retain a financial advisor to perform necessary accounting functions, to develop a business plan that will help turn the business around, and to develop and negotiate the terms of a plan of reorganization. Others include attorneys, trustee, examiner, creditors, security holders, and stockholders.

In liquidation proceedings under chapter 7 of the Bankruptcy Code, the financial advisor often assists in accounting for the distribution of the debtor's assets. If the liquidation proceedings are initiated involuntarily, the petitioning creditors will need the assistance of a financial advisor in establishing a case of insolvency, and the debtor will need a financial advisor's assistance in trying to prove a defense of solvency. An investigation may be required for specific purposes, such as by the debtor to defend a turnover proceeding or by a third party to defend a suit by the trustee alleging a preferential transfer.[3]

[3] Asa S. Herzog, "CPA's Role in Bankruptcy Proceedings," *Journal of Accountancy*, Vol. 117 (January 1964), p. 59.

The trustee as the appointed or elected representative of the creditors in a bankruptcy court proceeding most frequently finds it necessary to employ a financial advisor to examine the debtor's books and records and to investigate any unusual or questionable transactions. A corporation's past transactions may need investigation to determine whether any assets have been concealed or removed or any preferences, fraudulent conveyances, or other voidable transactions committed. Often, the debtor may have kept inadequate books and records, further complicating the situation. The financial advisor may help the trustee develop a business plan, and may negotiate the terms of a plan of reorganization.

Under section 1103 of the Bankruptcy Code, the creditors' committee is permitted to employ such agents, attorneys, and financial advisors as may be necessary to assist in the performance of its functions. The financial advisor can provide valuable assistance to the committee by reviewing the business plan and the plan of reorganization of the debtor. At times, the financial advisor may help the committee develop a plan. The committee may also retain its own financial advisor to examine the debtor's books and records and to investigate the activities of the debtor. The creditors' committee is expected to render an opinion on the plan of reorganization, and to do so it must have knowledge of the debtor's acts and property. It must know the value of the debtor's assets in liquidation and the nature of the transactions entered into by the debtor before proceedings began. Because financial advisors are most qualified to establish these facts, they are often engaged to perform an investigation of the debtor's operations so that the committee will be able to give an informed opinion on the actions to take, such as a search for preferences or fraudulent transfers.

The debtor's internal accounting staff is also actively involved in the proceedings. Staff members often provide information or advice that assists the debtor in selecting the appropriate remedy. They also provide the debtor's attorneys with the accounting information needed to file the bankruptcy court petition.

Accounting and financial advising services are needed by a large number of participants in both out-of-court and bankruptcy proceedings. See §1.1 of Volume 2, *Bankruptcy and Insolvency Accounting*, for a list of these parties.

§ 1.4 *Financial Advisor* Defined

It is not unusual to see several accountants or financial advisors involved in the same bankruptcy court proceeding. There may be independent accountants for the debtor, financial advisors for the debtor, internal accountants of a debtor company, financial advisors for the trustee, and financial advisors representing the creditors' committee or individual holder of claims. Many of the accounting functions may be performed by more than one firm. For example, each of the financial advisors retained will want to determine the underlying causes of failure. The term *financial advisors* is used here to refer to any financial advisor involved in the proceedings; where the service must be rendered by a particular financial advisor, the type of financial advisor is identified either in the text or at the beginning of the chapter. Many individuals who provide financial advice to companies in financial trouble are not CPAs and many of the boutique firms that provide business turnaround, bankruptcy, and

restructuring services do not practice as CPA firms, even though a large number of their professional staff are CPAs. The independent accountants that serve as auditors for the debtor are limited in the type of services that may be rendered for a client that may be in financial difficulty. For example the independent accountants could not be involved in preparing projections that may be included in the disclosure statement, but could assist the client in accounting for the restructuring including the adoption of fresh-start accounting. Services that may be performed by the independent accountant may also be referred to in this text as *financial advisory services*.

TOPICAL OVERVIEW

§ 1.5 Economic Causes of Business Failure

The first topic discussed in Chapter 2 is the economic causes that lead to business failure. A knowledge of the common causes of financial trouble can often enable the financial advisor to identify a potential problem, and corrective action can be taken before the situation becomes too serious. Methods of detecting failure tendencies are also described.

§ 1.6 Business Turnaround

Two critical aspects of the process of making a business with problems profitable again involve solving the operational problems and restructuring the debt and equity of the business. In this book, *turnaround* is used to mean the process of solving the operation problems of a business. It involves improving the position of the business as a low-cost provider of increasingly differentiated products and services and nurturing a competent organization with industry-oriented technical expertise and a general sense of fair play in dealing with employees, creditors, suppliers, shareholders, and customers.[4] Chapter 3 describes the business turnround process.

Restructuring will be used to mean the process of developing a financial structure that will provide a basis for turnaround. Some entities in financial difficulty are able to solve their problems by the issuance of stock for a large part of the debt; such is the case where the company is overleveraged. Others are able to regain profitability by improving cost margins through reduction of manufacturing costs and elimination of unprofitable products. However, the majority of businesses require attention to operating problems as well as changes to the structure of the business. Chapter 4 describes the process of restructuring the business out of court and Chapter 6 deals with the process of restructuring the business in the bankruptcy court. The business aspect of the restructuring process is discussed throughout the text.

§ 1.7 Alternatives Available to a Financially Troubled Business

In order to render services effectively in bankruptcy and insolvency proceedings, the financial advisor must be familiar with the Federal Bankruptcy Code

[4] Frederick M. Zimmerman, *The Turnaround Experience* (New York: McGraw-Hill, 1991), p. 11.

(title 11 of the United States Code). Chapter 5 begins with a discussion of the history of the bankruptcy law in the United States, and the provisions of the Bankruptcy Code are described throughout Chapters 5 and 6.

The debtor's first alternatives are to locate new financing, to merge with another company, or to find some other basic solution to its situation, in order to avoid the necessity of discussing its problems with representatives of creditors. If none of these alternatives is possible, the debtor may be required to seek a remedy from creditors, either informally (out of court) or with the help of judicial proceedings. To ensure that the reader is familiar with some of the alternatives available, they are briefly described in the paragraphs that follow. The general provisions of an assignment for the benefit of creditors are described in detail in Chapter 5. Often, debtors prefer to work out their financial problems with creditors by mutual agreement out of court; these settlements are described in chapter 4. A chapter 11 reorganization, the second major rehabilitation device for a debtor, is analyzed in Chapter 6 and throughout this book.

(a) Out-of-Court Settlements

The debtor may request a meeting with a few of the largest creditors and one or two representatives of the small claimants to effect an informal agreement. The function of such a committee may be merely to investigate, consult, and give advice to the debtor, or it may involve actual supervision of the business or liquidation of the assets. An informal settlement usually involves an extension of time (a moratorium), a pro rata settlement (composition), or a combination of the two. The details of the plan are worked out between the debtor and creditors, the latter perhaps represented by a committee. Such extralegal proceedings are most successful when there are only a few creditors, adequate accounting records have been kept, and past relationships have been amicable. The chief disadvantage of this remedy is that there is no power to bind those creditors who do not agree to the plan of settlement.

(b) Assignment for Benefit of Creditors

A remedy available, under state law, to a corporation in serious financial difficulties is an "assignment for the benefit of creditors." In this instance, the debtor voluntarily transfers title to its assets to an assignee who then liquidates them and distributes the proceeds among the creditors. Assignment for the benefit of creditors is an extreme remedy because it results in the cessation of the business. This informal (although court-supervised in many states) liquidation device, like the out-of-court settlement devised to rehabilitate the debtor, requires the consent of all the creditors or at least their agreement to refrain from taking action. The appointment of a custodian over the assets of the debtor gives creditors the right to file an involuntary bankruptcy court petition.

Proceedings brought in the federal courts are governed by the Bankruptcy Code. It will normally be necessary to resort to such formality when suits have already been filed against the debtor and its property is under garnishment or attachment, or is threatened by foreclosure or eviction.

(c) Chapter 11: Reorganization

Chapter 11 of the Bankruptcy Code replaces Chapters X, XI, and XII of the Bankruptcy Act, which applied only to cases filed before October 1, 1979.[5] Chapter 11 can be used as the means of working out an arrangement with creditors where the debtor is allowed to continue in business and secures an extension of time, a pro rata settlement, or some combination of both. Or, chapter 11 can be used for a complete reorganization of the corporation, affecting secured creditors, unsecured creditors, and stockholders. The objective of the reorganization is to allow the debtor to resume business in its new form without the burden of debt that existed prior to the proceeding.

One important aspect of the proceedings under chapter 11 is to determine whether the business is worth saving and whether it will be able to operate profitably in the near future. If not, then the business should be liquidated without incurring further losses. The new law allows the debtor—if it is determined that the business should be liquidated—to propose a plan that would provide for the orderly liquidation of the business without conversion of the proceedings to chapter 7 (the successor to straight bankruptcy). Another aspect of the new chapter 11 is that the debtor will in most cases be allowed to operate the business while a plan of reorganization is being proposed.

Prepackaged or prenegotiated chapter 11 plans are a common alternative to a regular chapter 11 filing. In prepackaged chapter 11 plans, before filing for chapter 11, some debtors develop a plan and obtain approval of the plan by all impaired claims and interests. The court may accept the voting that was done prepetition, provided that the solicitation of the acceptance (or rejection) was in compliance with applicable nonbankruptcy law governing the adequacy of disclosure in connection with the solicitation. If no nonbankruptcy law is applicable, then the solicitation must have occurred after or at the time the holder received adequate information as required under section 1125 of the Bankruptcy Code. A prenegotiated chapter 11 case is similar to a prepackaged bankruptcy filing except that the solicitation of the acceptance of the plan is done after the petition is filed, thus avoiding the need to file documents with the Securities and Exchange Commission (SEC). Once the bankruptcy court approves the disclosure statement in a prenegotiated chapter 11 filing, the solicitation and voting begins, followed by the confirmation of the plan.

The professional fees and other costs of a prepackaged or prenegotiated plan, including the cost of disrupting the business, are generally much less than the costs of a regular chapter 11. A prepackaged or prenegotiated bankruptcy may therefore be the best alternative.

A prepackaged or prenegotiated plan is generally thought to be most appropriate for debtors with financial structure problems (often created by leveraged buyouts [LBOs]), rather than operational problems. However, a prepackaged or prenegotiated plan may be used in most situations where an out-of-court workout is a feasible alternative. Recently, there has been an increase in the number

[5] Prior law (Bankruptcy Act) used *Chapter* and roman numerals (Chapter VII, Chapter XI, and so on) for chapter identification; the new law (Bankruptcy Code) uses *chapter* and arabic numbers (chapter 7, chapter 11, and so on).

of prepackaged or prenegotiated plans filed. If a prepackaged plan is going to be effective in solving operational problems, it is important that early action be taken before operations deteriorate to the point where a bankruptcy petition must be filed in order to prevent selected creditors from taking action against the debtor that would preclude any type of reorganization. In situations where a petition must be filed in order to obtain postpetition financing to operate the business (such as in a retail operation), a petition will have to be filed before any type of plan can be developed.

(d) Chapter 12: Adjustment of Debts of Family Farmers

To help farmers resolve some of their financial problems, Congress passed chapter 12 of the Bankruptcy Code. This chapter became effective November 26, 1986, and became law under a provision that allows the law to expire unless the expiration time period is extended by Congress. Congress allowed the law to expire October 1, 1998, but subsequently retroactively extended the expiration date to October 1, 1999, so that farmers could continue to use chapter 12. After extending the sunset date several times, the 2005 Act provided for chapter 12 to be permanent. A family farmer may use this chapter if his total debt does not exceed $3,544,525. Chapter 12 is designed to give family farmers an opportunity to reorganize and keep their land. Through bankruptcy, the farmers have the protection they need while they attempt to resolve their financial problems. At the same time, the law was passed for the purpose of preventing abuse of the system and ensuring that farm lenders receive a fair repayment of their debts.

(e) Chapter 13: Adjustment of Debts of an Individual with Regular Income

The new law allows some small businesses to use chapter 13, which, under prior law, had been used only by wage earners. However, as initially passed, only businesses that are owned by individuals with unsecured debts of less than $100,000 and secured debts of less than $350,000 may use this chapter. Effective for petitions filed on or after October 22, 1994, the Bankruptcy Reform Act of 1994 increased the debt limits for the filing of a chapter 13 petition as follows: for unsecured debt, from $100,000 to $250,000; for secured debt, from $350,000 to $750,000. On April 1, 1998, and at each three-year interval thereafter, the dollar amounts for the debt limits for a chapter 13 petition are to be increased, beginning on April 1, to reflect the change in the Consumer Price Index for All Urban Consumers that has occurred during the three-year period ending on December 31 of the immediately preceding year. The amounts are to be rounded to the nearest $25 multiple. Effective through March 31, 2010, the unsecured debt limit is $336,900 and the secured debt limit is $1,010,650.

Debtors must have income that is stable and reliably sufficient to enable them to make payments under the chapter 13 plan. As in a chapter 11 proceeding, the debtor will be allowed to operate the business while a plan is being developed that will, it is hoped, provide for the successful operation of the business in the future. The chapter 13 proceeding, a streamlined rehabilitation method for eligible debtors, is also discussed in Chapter 6.

(f) Chapter 7: Liquidation

Chapter 7 of the Bankruptcy Code is used only when the corporation sees no hope of being able to operate successfully or to obtain the necessary creditor agreement. Under this alternative, the corporation is liquidated and the remaining assets are distributed to creditors after administrative expenses are paid. An individual debtor may be discharged from his or her liabilities and entitled to a fresh start.

The decision as to whether rehabilitation or liquidation is best also depends on the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders should be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after rehabilitation must be determined (net of the costs of achieving the remedy). The alternative leading to the highest value should be followed.

Financially troubled debtors often attempt an informal settlement or liquidation out of court, but if it is unsuccessful, they will then initiate proceedings under the Bankruptcy Code. Other debtors, especially those with a large number of creditors, may file a petition for relief in the bankruptcy court as soon as they recognize that continuation of the business under existing conditions is impossible.

Exhibit 1-1 summarizes the most common alternatives available to the debtor in case the first course of action proves unsuccessful.

§ 1.8 Comparison of Title 11 of the United States Code with the Bankruptcy Act

The new bankruptcy law, signed by President Carter on November 6, 1978, and applicable to all cases filed since October 1, 1979, contained many changes from prior law. The new law is codified in title 11 of the United States Code, and the former title 11 is repealed. Exhibit 1-2 summarizes the changes brought

Exhibit 1-1 Schedule of Alternatives Available

Unsuccessful Action	Alternatives Available
Out-of-court settlement	Chapter 13 (small businesses only) Chapter 11—reorganization Assignment for benefit of creditors (state court) Chapter 7—liquidation
Chapter 13 (small businesses only)	Chapter 11—reorganization Assignment for benefit of creditors (state court) Chapter 7—liquidation
Assignment for benefit of creditors (state court)	Chapter 7—liquidation
Chapter 11—reorganization	Chapter 11—reorganization (liquidation plan) Chapter 7—liquidation

Exhibit 1-2 Comparison of the Provisions of Title 11 of the United States Code with the Bankruptcy Act

	Bankruptcy Act (old law)		Bankruptcy Code (new law)
Item	Chapter XI	Chapter X	Chapter 11
Filing petition	Voluntary	Voluntary and involuntary	Voluntary and involuntary
Requirements for involuntary petition		Must commit an act of bankruptcy	Generally not paying debts as they become due or custodian appointed in charge of debtor's property
Nature of creditors' committee	Three to eleven members elected by creditors	Usually not appointed	Seven largest holders of unsecured claims
Operation of business	Usually debtor-in-possession (at time receiver appointed)	Usually by trustee	Most cases debtor-in-possession
Appointment of trustee	Not appointed	Required if debts exceed $250,000	May be appointed (or elected) on petition after notice and an opportunity for hearing
Appointment of an examiner	No provision	No provision	(1) On request and after a notice and a hearing or (2) if unsecured debts exceed $5,000,000 after request. Purpose is to examine the affairs of the debtor
Preferences			
Time period	Four months prior to petition date	Four months prior to petition date	Ninety days prior to petition date (time period extended to one year for insiders)
Insolvency at time of payment	Required	Required	Required, but for 90-day provision insolvency is presumed
Exception for payments for business purposes and terms	No provision	No provision	Provided
Creditors receiving payment required to have knowledge of debtor's insolvency	Required	Required	Not required for 90-day requirement and required for payments to insiders

Exhibit 1-2 (*continued*)

	Bankruptcy Act (old law)		Bankruptcy Code (new law)
Item	Chapter XI	Chapter X	Chapter 11
Automatic stay	Provided for	Provided for	Provided for with some modifications regarding use of property
Setoffs	Allowed	Allowed	Allowed with new restrictions
Plan			
Submission	By debtor-in-possession	Normally, by trustee	Normally, by debtor-in-possession. However, if plan not submitted in 120 days or trustee appointed, trustee or creditors may submit plan
Coverage	Unsecured debt	All debt and equity interest	All debt and equity interest
Acceptance	Majority in amount and in number of each class of unsecured creditors	Two-thirds in amount of debt and majority in amount for equity interest	Two-thirds in amount and majority in number of holders in each class of those voting and two-thirds in amount of stock-holders voting
Disclosure statement	Not required	Formal statement filed with SEC	Required before can solicit votes for plan
Confirmation requirements	Best interest of creditors, feasible	Fair and equitable, feasible	Class not impaired or accept plan, best interest of creditors, feasible

about by the first major revision of bankruptcy law in the past 40 years and compares the provisions of the prior law with the new law as amended.

§ 1.9 Retention of the Financial Advisor and Fees

Financial advisors must be retained by order of the court before they can render services in bankruptcy court proceedings for the trustee, creditors' committee, or debtor-in-possession. For out-of-court settlements, the financial advisor obtains a signed engagement letter. Chapter 7 of this book describes and provides examples of the formal and informal retention procedures, and illustrates how financial advisors must clearly set forth the nature of the services to be rendered. The chapter also illuminates the factors to consider in estimating fees and keeping time records, and describes the procedure for filing a petition for compensation.

§ 1.10 Accounting Services

In addition to the usual accounting services performed for the debtor, the accountant provides information needed to negotiate with creditors or to file a petition in bankruptcy court, prepares operating statements, assists in formulating a plan, and provides management advising services. Chapters 8 and 9 provide information concerning the nature of these services.

The creditors' committee often needs a financial advisor to assist it in protecting the creditors' interest and supervising the activities of the debtor. Some of the services rendered by the accountant, which are described in chapter 10, include assisting the committee in exercising adequate supervision over the debtor's activities, performing an investigation and audit of the operations of the business, and assisting the committee in evaluating the proposed plan of settlement or reorganization. Additional services rendered by accountants relating to the valuation of the business or its component assets are discussed in Chapter 11.

A list of the services often rendered by accountants in the bankruptcy and reorganization area is presented in §1.2 of Volume 2, *Bankruptcy and Insolvency Accounting*.

§ 1.11 Special Investigation and Financial Reporting

Reporting on insolvent companies requires the application of procedures that vary somewhat from those used under normal circumstances. Emphasis in Chapter 12 of this book is on special procedures that differ from those used under normal conditions and on procedures that assist in the discovery of irregularities and fraud. Chapter 13 describes financial reporting during a chapter proceeding and Chapter 14 describes how to report on emerging from chapter 11. Chapter 15 describes the nature of the accountant's opinion associated with the reports.

§ 1.12 Tax Awareness

Chapter 16 covers the tax areas that the accountant should consider when rendering services for a debtor or creditor of a troubled company and points out how proper tax planning can preserve and even enlarge the debtor's estate.[6]

Beyond the scope of this book are nonuniform provisions under state or common law for judicial receivership proceedings and specialized provisions of the Bankruptcy Code for municipality, stockbroker, commodities broker, and railroad proceedings.[7]

[6] See Grant Newton and Robert Liquerman, *Bankruptcy and Insolvency Taxation, 3rd Edition* (Hoboken, NJ: John Wiley & Sons, 2005) for more information on the tax aspects of bankruptcy.

[7] A receiver may be an official appointed by a state court judge to take charge of, preserve, administer, or liquidate property designated by the court. The Commonwealth of Massachusetts specifically confirms the power of its judges to exercise this equitable remedy to appoint liquidating receivers at the request of creditors of dissolved or terminated corporations or of creditors of corporations that have failed to satisfy outstanding judgments against them. See, for example, Mass. Gen. Laws Ann. ch. 156B, §§ 104–05.

RESPONSIBILITIES OF INDEPENDENT ACCOUNTANT

§ 1.13 Responsibilities in General

Independent accountants are aware that their responsibilities to clients often extend beyond merely auditing the books and giving an opinion on the financial statements. They frequently give management an opinion on the progress of the business, its future, and avenues of improvement, not only in the system of record keeping, but in the overall management of the enterprise. The intensity of involvement required depends on several factors, including an individual judgment to be made by the accountant.

Independent accountants owe some degree of responsibility to third parties interested in their clients' affairs. This includes the duty to remain independent so that an unbiased opinion can be rendered. The accountant is also relied on to reveal all those facts that might be relevant and important to other persons. This again involves judgment as to the level of disclosure that is appropriate (see Chapter 8).

The accountant's position and responsibilities as they relate to a client experiencing financial difficulties and to third parties interested in the proceedings will be introduced in the remaining sections of this chapter.

§ 1.14 Observation of Business Decline

The first and most crucial step in any situation involving a business in financial trouble is recognizing that a problem exists. This is important because corrective action should be taken as soon as possible, to halt any further deterioration in the firm's position.

Many people normally maintain close contact with a business—management, employees, lawyers, accountants, customers, competitors, suppliers, owners, and the government, to list only the most obvious ones. Few of these persons, however, would be in a position to recognize when the enterprise is headed for trouble. Normally, this requires someone who intimately works with the financial data and is trained in analyzing such information. Usually, only the financial managers of the business, such as the treasurer and controller, or the independent accountants employed by the firm have these qualifications.

Some independent accountants who conduct only an annual audit and do not maintain close contact with their client throughout the year are often of little assistance in recognizing a potential problem. However, in many small and medium-size businesses, the accountants not only conduct the annual audit but review quarterly and monthly statements and render various types of advisory services as long as the performance of these services does not cause the accountant to lose his or her independence. In these situations, the accountants are aware of what has been occurring in the major accounts, and in the firm as a whole and, because of their education and experience in business finances, they should be able to identify when an enterprise is headed for trouble and alert management to their suspicions. Thus, because of the nature of both the type of work they do and the ability they possess, accountants are in an excellent position to identify any tendencies to failure. However, the amount

of advisory work the independent accountant can perform for the debtor may be limited if the accountant expects to continue as auditor for the client. To avoid losing the right to continue as the client's auditor because of a lack of independence, the independent accountant may recommend the client seek professional assistance from another accountant or financial advisor.

As an example, the independent accountants of a New York garment business had served as auditors for the company for many years. The company had been operative through successive generations of the same family for approximately 90 years. As a consequence of changing fashion styles, the company experienced a few consecutive years of operating losses. The accountants noticed that the company was not taking any action to correct the loss trend—the president, in fact, seemed incapable of reversing the situation. Although there was still some working capital and net worth that might have enabled the company to obtain credit and continue in business, the accountants suggested that the following actions be taken:

- Discontinue placing orders for raw materials for the upcoming season, other than to permit completion of orders on hand.
- Start terminating personnel in the areas of design, production, and administration.
- Offer the plant facilities for sale.
- Liquidate inventories in an orderly fashion.
- Meet with creditors to explain the situation.

The accountants' suggestions were followed and the plants were sold, resulting in a settlement with creditors at 87.5¢ on the dollar. The stockholders received payment in full on a mortgage loan they had made to the company. Had the accountants' suggestions not been followed, further substantial operating losses would most probably have been incurred; the creditors would have been fortunate to receive a distribution of 15 percent, and it is doubtful the mortgage loan would have been paid in full. It should be realized that in today's environment, the performance of such functions may result in the independent accountants losing their independence; however, the client may no longer need the audit services of independent accountants.

To be able to recognize a potential problem, accountants need to have an understanding of the definition of financial failure, the nature of insolvency, and the most common causes of financial difficulties. They must have a familiarity with the characteristics of business decline, which include lower absolute sales and slower growth in sales, poorer cash flow and weak cash position, deteriorating net income, insufficient working capital, large incurrence of debt, and high operating costs and fixed expenses. These symptoms are normally found in the accounting records, and the accountant is most likely to be first to recognize them.

§ 1.15 Responsibility to Client

At the very first suspicion of pending financial trouble, independent accountants have a duty to alert management to the situation, submit as much

supporting information as is possible, describe the various alternatives available to reverse the deterioration, and advise on what avenue should be chosen as a remedy. All these measures are taken to implore the client to begin corrective action before the situation becomes more serious, and the accountant should be concerned with pointing out to the client ways of avoiding insolvency. The responsibility of the independent accountant where fraud is involved is described in Chapter 12.

Should the situation become serious enough to warrant some type of remedy outside the usual business corrective measures, the accountant must make a thorough analysis to determine the most appropriate action to be taken (Chapter 2). This involves an investigation into the causes of financial difficulty and steps that will correct the trouble. The accountant must therefore be familiar with the various alternatives available and when they are most appropriate. This involvement by the accountant should aid the debtor in adopting the rehabilitation procedure most likely to be successful.

It is also the accountant's responsibility to know the procedures required under each alternative remedy. In an out-of-court settlement, this involves awareness of the methods that have proven successful in particular situations. For example, in an informal composition, the accountant should know when it is best to have all creditors meet and under what circumstances only a representative group is more advisable. When formal proceedings are initiated, it is imperative that the accountant know what information is required on the bankruptcy court petition and what schedules must be filed. Otherwise, it would not be possible to converse with the debtor's attorney, a failure that could conceivably delay the settlement and cause further deterioration in the client's position.

Timing is crucial in a situation involving insolvency. Should the accountant fail to alert the debtor to the situation and urge some action, the creditors might move first and attempt legally to seize the assets. Speed is then important if the debtor wishes to file a chapter 11 petition and remain in possession of the business.

§ 1.16 Advice on Selection of Attorneys

One of the first steps of a debtor faced with financial difficulties is the employment of legal counsel. When a company realizes that it will be unable to continue profitable operations or pay liabilities as they become due, it should quickly seek a lawyer to help effect a compromise or an extension of the indebtedness. Because the independent accountant is often the first professional the client contacts concerning financial difficulties, the accountant is frequently asked for advice as to the selection of a special bankruptcy attorney.

There are many advantages to the accountant's involvement at this point. Frequently, accountants are aware of those attorneys most familiar with bankruptcy and insolvency cases, and can recommend someone with adequate experience and knowledge. By suggesting a lawyer of known reputation, the accountant and the debtor's creditors are assured of working with someone in whom full confidence can be placed. It is imperative that the accountant and attorney be able to work well together. The accountant should be present at the meetings with the debtor and provide the counsel with an overall view of

the debtor's financial condition and the events that preceded it, including the basic facts and information about the business, its history, and the causes of its present difficulties.

Because they are most familiar with the attorneys best qualified in this field and will be required to work with the lawyer chosen by the debtor, accountants have good reason to be involved in the selection process. However, the situation may give rise to questions concerning an accountant's independence as discussed above. If an attorney is recommended more on the basis of friendship with the person than on qualifications, the accountant is not being fair to the client. The accountant must be very careful not to have a vested interest in any attorney suggested.

§ 1.17 Other Steps to "Manage" the Proceedings

Financial advisors are often intimately involved in every aspect of a bankruptcy or insolvency case. They may "manage" the case from the initial discovery of financial trouble, suggesting the best remedy to seek, advising regarding any necessary alterations or modifications of the plan chosen, and monitoring the operations of the debtor by reviewing the operating results during the proceedings. They maintain close contact with the creditors, working with their committee in an effort to find the most advantageous settlement for them. They then provide all the financial information concerning the debtor's progress and make sure all interested parties are aware of what is occurring. Financial advisors can help determine the going-concern or reorganization value of the business. This value is then used to determine the amount of debt that the entity emerging from bankruptcy can service and also help the interested parties agree on the terms of a plan. Financial advisors representing the creditors may also be involved in helping the creditors determine the value of the debtor's business. If all parties involved can reach an agreement about the value of the business, the first major step toward agreeing on the terms of the plan has been accomplished. Possibly more than any other outside party, the financial advisor is responsible for the smooth and successful rehabilitation of the debtor. This is primarily because of a close involvement with all the interested parties, including the debtor, creditors, attorney, trustee, and governmental agencies. However, it should be realized that the performance of many of the functions listed above may preclude an independent accountant serving as the client's auditor.

PROFESSIONAL CERTIFICATION

§ 1.18 Certified Insolvency and Restructuring Advisors

The Association of Insolvency and Restructuring Advisors (AIRA) has developed an educational program covering an appropriate common body of knowledge designed specifically for those who specialize in the area of bankruptcy and troubled business. This educational program covers a wide range of subjects, preparatory to a written examination. Completion of the course of study and passing of the examination, in combination with a comprehensive experience

requirement, will lead to certification by the AIRA as a Certified Insolvency and Restructuring Advisor (CIRA).

(a) Purpose

The purpose of the CIRA program is to recognize by public awareness and by certification those individuals who possess a high degree of specialized professional expertise in the area of business bankruptcy and insolvency. Such experience includes accounting, taxation, law, finance, and management issues related to business bankruptcy and reorganization.

In addition, the CIRA certification will:

- Provide a special recognition standard for the public, the bankruptcy court system, governmental agencies, and other professionals.
- Differentiate certified specialists from those persons who do not possess the required experience, education, and technical skills.
- Serve as a credential to support the qualifications of those who possess this special certification.
- Promote a higher degree of specialized skills.

(b) Requirements for Certification

To be eligible to enroll in the course of study and take the examination, the candidate must:

- Be a regular member in good standing in the AIRA.
- Satisfy one of the following requirements:
  - Be a continued license holder as a Certified Public Accountant, Chartered Accountant (or equivalent license), or Certified Management Accountant.
  - Possess (at least) a bachelor's degree from an accredited college or university and four years of accounting or financial experience.[8]

To obtain the certification, the following three requirements must be satisfied:

1. Complete five years of accounting or financial experience.[9]
2. Complete 4,000 hours, within the previous eight years, of specialized insolvency and reorganization experience.
3. Complete the CIRA course of study and pass the uniform written examination.

[8] Relevant experience includes public accounting, crisis management, consulting, investment banking, credit management, loan workout, or applicable government experience (e.g., financial analyst with Office of the U.S. Trustee, Pension Benefit Guarantee Corporation, FBI and SBA, etc.).
[9] *See* note 8.

(c) Course of Study

The course of study is divided into three parts:

1 Managing turnaround and bankruptcy cases
2 Plan development
3 Accounting, financial reporting, and taxes

Each part consists of a two-and-a-half-day course and a three-hour examination taken during the last half-day of attendance.

§ 1.19 Certification in Distressed Business Valuation

Valuation has always been at the core of financial restructuring, mainly because it helps determine "How big is the pie?" and "How big a slice am I entitled to?" Valuation analysis is also used throughout a bankruptcy proceeding in such widespread ways as determining: (1) whether an equity committee should be appointed, (2) whether a lender is secured, (3) whether a company is/was insolvent at particular points in time, and (4) what the post-emergence balance sheet should look like.

The Association of Insolvency and Restructuring Advisors (AIRA) established in 2004 the professional designation of Certification in Distressed Business Valuation (CDBV), designed to train and accredit professionals who evaluate distressed assets, including distressed and/or bankrupt companies. The program consists of three parts:

Part 1: Understanding the Bankruptcy Code and How It Impacts Valuation of Distressed Businesses—a course providing a comprehensive understanding of the concepts in the Bankruptcy Code important in valuing businesses in distress, including those in chapter 11. This course is waived for applicants holding a CIRA or CTP certificate. The two-and-a-half-day course consists of two days of instruction followed by a three-hour exam on the third day.

Part 2: Advanced Business Valuation—a course where professionals develop a comprehensive understanding of the principles and concepts of business valuation. Part 2 is waived for those applicants holding one of the following certifications: ASA-Business Valuation, CBA, CFA, CPA/ABV, CVA/AVA.

Part 3: Application of Business Valuation Concepts to Bankruptcy and Other Distressed Situations—a course covering application of these concepts in depth to the valuation of distressed debt and businesses, including those in chapter 11.

Parts 2 and 3 each are three-and-a-half-day courses, each consisting of three days of instruction followed by a four-hour exam on the fourth day.

Additional information about the CIRA and CDBV programs can be obtained by contacting the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501; phone (541) 858-1665; website www.aira.org.