While reading some forum postings in the DDIC website, I began to wonder how they valued bonds for companies that file bankruptcy. Do bond holders receive any money? What happens to the company and the assets? What happens to the employees? We seek to answer such questions with an overview look at corporate restructuring.

A company can go bankrupt due to **1) liquidity issue, 2) inability to refinance an upcoming maturity of bonds.**

1) Liquidity issue- due to lower sales, higher costs, whatever reason, the company can't pay installment interest payments.
2) Capital issue- if the lump sum fixed income is maturing next year, i.e. $100 MM, the company only has $50 MM in cash and will generate $25 MM in Free cash flow, they will be short $25 MM. If the company can't refinance the bond, by issuing a new bond, or somehow extending the maturity for the principal, the company will default.

Chapter 7 vs. Chapter 11 Bankruptcy

Chapter 7 is worst case scenario. Assets are turned over to a trustee, and all business functions cease. Assets are sold to pay back creditors and shareholders don't receive anything.

Chapter 11 is a tad different. Business continues as normal, but a committee representing creditors and shareholders lead a restructuring process. If no compromise is made, company assets are most likely sold to pay back creditors.

Value of Bond During Restructuring

"Assuming a 6x exit EV multiple, the senior notes will be the fulcrum security and given that currently public comps are trading in the 8-10 EV/EBITDA range and MidOcean bought the company at ~8x EV/EBITDA, the notes will "own" the equity upside." Source: Distressed Bond Forum

Fulcrum security is the debt instrument most likely to turn into an equity investment. So Let's assume EV is $100 MM and with a 6x EV Multiple, the EV is $600 MM. If there is $500 MM in secured lending and $200 MM in unsecured lending, the $500 MM secured will be paid off with the unsecured lenders receiving equity in the reorganized entity.