Bankruptcies are Rising - How is That Impacting Equity Holders?

Learon Bird, Consultant - Regulatory Enforcement and Complex Litigation

Corporate bankruptcies in the U.S. rose to a 10-year high in 2020, largely due to the effects of the COVID-19 pandemic. One of those effects was a rise in retail investing and day trading, often on mobile platforms like RobinHood. When GameStop announced dismal earnings amid hundreds of store closures back in December 2020, talk of an inevitable bankruptcy arose, but soon subsided. The social-media-fueled small investor frenzy that followed is compelling drama for investors, financial advisers, regulators and legislators, and it is still unclear how it will all ultimately play out. Though GameStop may not file for bankruptcy, other retailers, including JCPenney, 24 Hour Fitness, Lord & Taylor, Payless, and hundreds of other companies have. What happens to stockholders when this occurs?

Bankruptcy can be a wild ride for common equity holders. As a rule, investors who take the least risk (typically earning the lowest rates of return) are paid first in a bankruptcy proceeding. The 'waterfall' of repayment starts with (1) secured creditors (lenders who have collateral), then (2) unsecured creditors (which often includes a company's suppliers), then (3) preferred shareholders and finally, if any money is left, (4) holders of common stock. Since a company can only file for bankruptcy if it cannot pay its debts as they come due, it is a true rarity for a company in bankruptcy to have enough money to pay its debts with anything left over for holders of preferred equity, let alone holders of common equity.

Because common shareholders are the last in line to be paid, they almost always get nothing from the bankruptcy. At the start of a bankruptcy, a stock's ticker will be changed to a 5-character ticker ending in Q. At the conclusion of the bankruptcy case, with no chance of a recovery, the stock is delisted. Consider, for example, General Motors' bankruptcy of 2009. GM's common stock traded under the ticker GMGMQ immediately after its bankruptcy. After limping along during the bankruptcy proceeding, the stock ticker was changed to MTLQQ and eventually cancelled – but not before investors, who must not have understood this process, proceeded to buy up the stock, sending it from $.75 to $1.20.[1]

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One exception to this norm is worth mentioning. It illustrates how difficult it is for equity holders to obtain a recovery in bankruptcy, and what a recovery looks like in those rare instances. As an initial matter, equity holders are typically required to pay their financial advisors and legal counsel in full, out of their own pockets. Washington Mutual (WAMU) was one of those rare exceptions in which equity holders were able to gain standing to appear in court, received court approval for the bankruptcy estate to pay their legal and professional fees, and even received a small recovery in the final bankruptcy plan. I attended multiple hearings in which equity holders and their representatives traveled to Wilmington, Delaware and addressed the court in an effort to advance their cause prior to obtaining formal approval; the equity holders paid all of these costs themselves.

In approving the bankruptcy plan of reorganization, Judge Walrath of the Delaware Bankruptcy Court specifically called out the substantial contribution equity holders made in the bankruptcy and the significant recovery they would receive. In this case, common and preferred stockholders were to receive stock in a new entity valued at $210 million that would be funded by certain WAMU noteholders (creditors) through the bankruptcy process.[2]

That said, the common stock of WAMU dropped from $13.61 on January 1, 2008 to $.045 on the day Judge Walrath approved the bankruptcy plan, February 17, 2012. Even considering this highly unusual result, which was considered a "huge win,"[3] the result was a 99.7% loss of value for common shareholders. During the course of its bankruptcy, WAMUQ (the renamed Washington Mutual common stock) saw its price vary wildly, from under $.10 up to a high of $.40 before finally dropping to $.045.

Financial advisors and investors may want to carefully consider their investment strategy prior to investing in a stock with a 5-character ticker ending in "Q." Because these tickers are associated with companies in bankruptcy and equity holders are at the end of the payment line, a clear exit strategy should be in place prior to purchasing these investments. Remember, a 'home run' for equity holders in a bankruptcy proceeding amounts to pennies per share.

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Learon Bird is a financial litigation consultant with Bates Group. Prior to joining Bates, he practiced bankruptcy law in Wilmington, Delaware for 9 years, regularly appearing before all the judges on the bench at that time, including Judge Walrath.

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Learon Bird

Consultant, Regulatory Enforcement and Complex Litigation

lbird@batesgroup.com

Endnotes

1 https://money.cnn.com/2009/06/12/markets/thebuzz/index.htm?section=money_latest

2 On the day Judge Walrath issued her oral ruling confirming WAMU's plan of reorganization, I published a brief summary of her ruling: https://insolvency.foxrothschild.com/2012/02/washington-mutuals-plan-of-reorganization-has-been-confirmed/

3 https://www.seattletimes.com/business/tiny-shred-of-bankrupt-wamu-emerging-to-uncertain-future/

Bates Group

5005 Meadows Road,
Suite 300
Lake Oswego, OR 97035
(503) 670-7772
contact@batesgroup.com

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