Here is Why You Should NEVER But a Common Stock of a Company in Chapter 11

Americans are ever hopeful, and most of us are natural bargain hunters. But in the case of companies reorganizing in bankruptcy, the apparent bargains when their shares trade at under a dollar are nothing but deadly money traps. This article will explain what happens during a bankruptcy and what becomes of the common stock of the company involved.

When a company files for bankruptcy protection, a federal court oversees its "reorganization." Claims of people and entities that are owed money come first. Stockholders come last if at all. Preferred Stock owners, if any, come before those who own the common shares. The order of priority for claims is approximately as follows:

Taxes owed
Wages owed
Trade Creditors (suppliers etc., if the company is to continue operating)
Bank lenders, Commercial Paper and Bond holders (order depends on the relative strength of covenants in each document)
Preferred stock if any
Common Stock IF AT ALL

In a very high percentage of cases (well upper 90s!) the common stock of the old stockholders is wiped out. It is valuable only as a souvenir or as wallpaper. If the company emerges from the bankruptcy process as a continuing going concern, it will issue new common stock. Who gets that? People and entities on the list starting below the "wages" line. In many bankruptcies, the reason for the corporate failure is the use of too much leverage (is that word familiar from the current financial news?). In order to keep operating, the company must stop paying so much interest on debt and dividends on its preferred stock (if any). So the court converts old debt and preferred stock to new common shares. Common holders get nothing in virtually all cases.

The last major USA bankruptcy in which common holders were not 100% wiped out was that of Texaco in the late 1980s. It sought court protection from huge lawsuits under some complex contracts, and those suits were resolved by the court, so the common shareholders remained in place.

In order for common stock to not be cancelled from a bankruptcy, there must be net assets left over after the claims of all higher-priority claimants are satisfied, ***at 100 cents on the dollar!*** This is extremely rare. If the bankrupt company could have made good on its obligations, it likely would not have needed to declare bankruptcy. The way the senior claims are satisfied is NOT in cash (the company does not have enough!), but by issuing paper called new common stock.

Currently there are reports in the financial press of ever-optimistic individual investors taking a flyer on companies in bankruptcy. One example is Lehman Brothers. The attitude is, it was always a great company, so maybe I will get luck when it recovers; I'll buy the stock for 25 or 50 cents a share and hope for the best. HERE IS REALITY: the stock is going to zero. Who are the buyers that are buying the shares that others are selling – so that the price is not already zero? Speculators who had sold short and are now buying back (covering) to take their profits, and overly optimistic fools.

United Airlines was a recent example of a typical bankruptcy. The common shareholders were totally wiped out. Employees and banks and bond holders were given new common stock, which began trading after the court protection ended. The old common stock was cancelled, and is worthless forever. The old common shares traded at about a dime and the new common, trading at many dollars initially, is absolutely not related to the old. So when you see a formerly bankrupt company's stock quoted again at an apparently robust price, do not be deluded: that is NOT the old common miraculously come back to life.

In the cases of bankruptcies of financial institutions (brokers, banks, etc), it is extremely unlikely that anything could possibly be left for the common owners. Why? First, the garbage assets held are almost certainly worth less than they are carried on the books for. Second, the leverage involved means any tiny losses on assets are magnified in terms of depleting any remaining equity. And third, there is almost always preferred stock, and it must be made good at 100 cents on the dollar IF there is anything to be left for the common owners. That is highly unlikely. Oh, yes, and the lawyers and consultants and accounts will get paid before the shareholders! Best advice: don't go there for any reason! Don't fantasize that a miracle could happen. People wistfully ask, How far down can those 50-cent shares go? Answer: Fifty cents, to zero. And they WILL.

(If you are unlucky enough -- or a bad enough procrastinator -- to own such a stock, sell it before it stops trading so you will have a closing sale transaction for tax purposes. Trying to prove your loss later will be costly and time-consuming – well beyond the brokerage commission you pay now.)