3 Aspects Of Value Preservation For Restructuring Cos.

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Large-scale bankruptcies such as Sears Roebuck and Co. continue to make headlines, following a string of closures of branded retailers in 2018. At its annual conference in January, the American Economic Association, or AEA, offered a session on financial distress and resolution providing interesting insights from some of the latest academic research on companies in distress and approaching default and bankruptcy.

Three papers in particular covered research on mechanisms that protect and preserve value of distressed companies attempting to navigate through different stages of the restructuring process. The first paper discusses how CEO compensation is being redesigned in order to enhance retention and preserve incentives in light of declining operational performance and stock price. The second paper provides evidence that a distressed company is more likely to reorganize in a cost-effective out-of-court restructuring if its creditors simultaneously hold both debt and equity stakes in the company. The third paper examines the impact of judicial experience on bankruptcy proceedings, finding that new bankruptcy judges, after two to four years on the bench, manage large cases in a manner similar to more experienced judges in terms of outcomes such as time spent in bankruptcy, probability of reorganization rather than liquidation and debt recovery rates.

Payday Before Mayday: CEO Compensation Contracting for Distressed Firms

The first paper was authored by Boston College professors Mary Ellen Carter and Edith Hotchkiss and Texas A&M University professor Mahdi Mohseni. Drawing their conclusions from analysis of CEO contracts for more than 1,400 U.S. public firms in the period 1998 to 2015, the authors researched different designs for effective CEO compensation, given changes in corporate financial positions as firms approach default. Speaking about her research, Hotchkiss noted, "When corporate performance declines, companies must consider adapting CEO incentives to the significant changes in liquidity needs they face."

Whether the company's directors and shareholders decide that the incumbent CEO or a new CEO is the right person to lead the company through its financial distress, compensation structure should be examined to ensure that the CEO's interests are aligned with those of shareholders, or, if the company is in a state of heightened distress, with the interests of creditors. The objectives of shareholders and creditors typically differ, and CEO incentives may need to be realigned accordingly.

Distressed firms experience significant stock price declines, which reduce CEOs' alignment with shareholders and which may also make equity compensation ineffective for retention purposes. Distressed firms may also fare poorly on earnings, return on assets or other accounting-based measures of performance, making the use of such accounting-based measures both disincentivizing and at odds with the immediate needs of the firm: maintaining adequate liquidity, and protecting and preserving the going concern value of the distressed company. For these reasons, firms facing financial distress contract differently with CEOs.

The paper finds that distressed firms change CEO contracts in several ways. First, the authors find that distressed firms are more likely to adopt performance-based compensation contracts using targets based on cash flow rather than accounting-based metrics, especially following covenant violations.

The authors also find that distressed firms set performance targets farther above prior (poor) performance, likely due to pressure from shareholders or creditors. Finally, distressed firms are less likely to use discretionary bonuses rather than performance-based bonuses. The researchers additionally observe that changes in contracting increase in frequency and extent as firms approach default.

Debt-Equity Simultaneous Holdings and Distress Resolution

The second paper was prepared by University of South Carolina professor Yongqiang Chu and professors Ha Diep Nguyen and Wenyu Wang from Indiana University, Jun Wang from University of Western Ontario and Wei Wang from Queen's University. For their study, the authors compiled a unique data set of 579 out-of-court restructuring events and 605 bankruptcy filings of U.S. firms with at least $50 million in assets in the period 2000 to 2014.

The authors find that distressed companies are more likely to reorganize in a cost-effective out-of-court restructuring or workout if their creditors simultaneously hold their debt (whether loans or bonds) and equity. Discussing his research, professor Wei Wang commented, "A workout is more likely than a bankruptcy filing when the creditors have larger equity stakes or bankruptcy costs are higher. Distressed firms with simultaneous holdings also experience higher stock returns during the resolution of distress, allowing investors to capitalize on the cost savings of an out-of-court resolution."

As there is neither an accepted definition of what constitutes a formal private resolution nor a database that tracks such restructurings, identifying out-of-court restructurings is an empirical challenge. In order to identify these private resolutions, the authors utilize a comprehensive set of data sources, including firms' stock returns and financial characteristics, news headlines, loan covenant violations and textual analysis of corporate filings.

The paper's main analysis provides insights on the relationship between a distressed company's likelihood of out-of-court restructuring versus filing for bankruptcy and three different types of simultaneous holding of the distressed company's debt and equity by financial firms: loan-equity dual holding, bond-equity dual holding and loan-bond-equity triple holding. The authors estimate that the presence of any of these types of simultaneous holding increases the likelihood of an out-of-court restructuring by 20 to 45 percent above the average likelihood of a private resolution, calculated across their full sample at 50 percent.

The authors find that the incentive to facilitate a cost-effective private solution is greater when simultaneous holders maintain larger equity positions in the distressed company or when the expected magnitude of bankruptcy costs are higher, as measured using firm size and asset specificity of the distressed companies.

Finally, the paper examines post-resolution stock performance to see if simultaneous holders can capitalize on the cost savings of an out-of-court restructuring. The authors estimate that during the resolution process firms with debt-equity simultaneous holdings experience monthly stock returns 4 percent higher than firms without those types of holdings. This finding indicates that there is a path unique to simultaneous holders to capitalizing on the savings from an out-of-court resolution.

Learning by Doing: Judge Experience and Bankruptcy Outcomes

For the third paper, the authors — professors Benjamin Iverson from Brigham Young University, Joshua Madsen from University of Minnesota, Wei Wang from Queen's University and Qiping Xu from the University of Notre Dame — collected court documents and biographical information on judges in every Chapter 11 filing by a U.S. public firm with more than $50 million in assets between 1980 and 2012. These cases were overseen by 309 bankruptcy judges in 75 bankruptcy courts.

Summarizing the study findings, Iverson says, "We found that the level and type of a judge's experience does make a difference in the bankruptcy process. First, as with any skilled job, judges face a learning curve early in their tenure. After about four years on

the bench, judges manage large cases in a manner similar to more experienced judges, in terms of outcomes. Second, judges who oversee more business cases and in a wider variety of industries gain experience and move up the learning curve more quickly."

The research indicates that judges' experience leads to greater efficiencies both over time and by way of case diversity and that judges' exposure to relevant tasks and exposure to a variety of tasks during their early years as a bankruptcy judge help accelerate their learning. In examining such metrics as speed of ruling, case duration, likelihood of emergence, refiling rates, and recovery rates for creditors, the authors find that after four years on the bench judges manage large cases in a manner similar to more experienced judges. In addition, judges who oversee a broader mix of firm sizes and a greater diversity of businesses are able to resolve large Chapter 11 cases more quickly.

The authors also show that the judges' learning curve has significant consequences for creditors, estimating that recoveries at plan confirmation with an experienced judge are 5 percent higher than with a new judge, all else equal. Finally, the authors attribute these results solely to differences in judges' experience, as they determined that law firms and counsel learning judges' individual preferences and style had little influence on the outcome differences they found.

Conclusion

This article highlights interesting insights from some of the latest academic research on companies in distress and approaching default and bankruptcy. The papers covered CEO compensation in distressed companies, effects of debt-equity simultaneous holdings on likelihood of cost-effective workouts, and the impact of judicial experience on bankruptcy proceedings.

Professor Kose John from New York University, the chair of the session at the AEA conference where these papers were presented, commented, "As the U.S. is potentially approaching the start of another cycle of corporate distress and bankruptcy, academic research such as this is increasingly relevant for policy makers, executives, investors, attorneys, judges and consultants in the bankruptcy space."

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