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Bank loans and troubled debt restructurings ☆

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ABSTRACT

This paper examines the relation between the number and type of lenders that participate in corporate loan facilities and the nature of troubled debt restructurings. We find that loans from traditional bank lenders are significantly easier to restructure out of court than loans from institutional lenders. We also find that the existence of a past banking relationship between the borrower and the lead arranger of a syndicated loan adversely affects the ease of restructuring. Finally, we find that reliance on loans that are held in part by collateralized loan obligations (CLOs) is positively related to the likelihood of a prepackaged bankruptcy, consistent with greater holdout problems when loans are held by CLOs. Overall, our findings suggest that the role of banks in the restructuring process is quite different when bank loans are diffusely held or securitized.

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1. Introduction

It is generally assumed that bank loans are easier to renegotiate or restructure in financial distress than public debt and trade credit.[2] This assumption is based, in part, on the idea that bank loans are associated with more concentrated ownership, which reduces the severity of holdout and free-rider problems in out of court debt restructurings. In addition, achieving a consensus on a debt restructuring involving bank debt may be easier because bank lenders are thought to be more sophisticated than other kinds of lenders and better informed due to their ongoing involvement in monitoring covenants and collateral, which in turn may reduce the information asymmetries between the borrower and creditors that can derail out of court restructurings. Moreover, banks may be more willing than "arm's length" creditors to provide concessions to a borrower outside of bankruptcy, since banks may obtain benefits from maintaining an existing relationship with the borrower in the form of future information rents and revenues from non-lending businesses. Consistent with the relative ease of restructuring bank debt, Gilson, John, and Lang (1990) (henceforth GJL), using data from the period 1978 through 1987, find that financially troubled firms that owe more of their debt to banks are more likely

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[2] See, for example, Bulow and Shoven (1978), Smith and Warner (1979), Hart and Moore (1995), Bolton and Freixas (2000), and Hotchkiss, John, Mooradian, and Thorburn (2008).

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to succeed in restructuring their debt out of court and avoid a presumably more costly Chapter 11 bankruptcy.[3]

Since the end of GJL's sample period, loan markets have undergone a number of significant changes that have potentially changed the role of bank loans in the restructuring process. Perhaps most important have been the growth of loan syndications (and a corresponding decline in single lender loans) and the entry of nonbank lenders (i.e., institutional lenders such as collateralized loan obligations (CLOs) and asset management firms (hedge funds, private equity funds, mutual funds, etc.) as well as investment banks) into the loan market as main providers of term loan funding for highly levered firms.[4] While previous studies have pointed out that the growth of loan syndication and institutional involvement in the loan market may lead to reduction in monitoring and thus increase borrower–lender agency problems (see, e.g., Taylor and Sansone, 2006; Sufi, 2007; Wang and Xia, 2014), how these changes may affect the restructuring process has not, to our knowledge, been previously examined.

In this paper, we examine the relation between the type and number of lenders that provide loan funding and the nature of the restructuring process for firms in financial distress. We use a hand-collected sample of 336 debt restructuring transactions (171 out of court restructurings and 165 Chapter 11 bankruptcies) by publicly traded industrial U.S. firms during the 1999 to August-2012 time period. As explained later, our sample selection criteria are similar to the criteria used by GJL, thus facilitating a comparison of recent distressed debt restructurings to those in the 1970s and the 1980s.

We begin by examining whether a firm's reliance on bank loans (measured by bank debt to total liabilities) is related to the likelihood that the firm restructures its troubled debt without entering bankruptcy. We first use a broad measure of bank loans that includes term loans and lines of credit funded by commercial and investment banks, insurance companies, finance companies, and institutional lenders. We then examine differences in impact of bank loans funded by traditional bank lenders (commercial banks and insurance companies) and institutional lenders.[5] Using the broad definition of bank borrowing, we find no significant relation between the likelihood of an out of court restructuring and a firm's reliance on bank financing. However, we find a positive and significant relation between reliance on traditional bank funding and likelihood of restructuring outside of bankruptcy. In sharp contrast, we find a *negative* and statistically significant relation between the likelihood of an out of court restructuring and reliance on institutional loans (defined as loans held by at least one institutional lender).

We next distinguish between institutional loans by whether or not they were held by CLOs. We find that the negative and significant relation between the likelihood of an out of court restructuring and reliance on institutional loans is driven entirely by reliance on loans held by CLOs. Indeed, we find evidence that loans held by CLOs are *more* difficult to restructure outside of bankruptcy than any other debt claim, including public debt.

We also investigate the relation between the likelihood of restructuring and the number of lenders. We find a positive and significant relation between the likelihood of a restructuring and reliance on traditional bank loans only for loans funded by a single commercial bank. We find no significant relation between the likelihood of an out of court restructuring and reliance on syndicated bank borrowing. Moreover, we find no evidence that the likelihood of an out of court restructuring changes as the number of lenders in traditional bank loans increases beyond two. Turning to institutional loans, we find a *negative* and statistically significant relation between the likelihood of an out of court restructuring regardless of the size of the lending syndicate.

We also examine the importance of holdout problems by examining the relation between reliance on loans held by CLOs and the likelihood of a prepackaged bankruptcy versus an out of court restructuring. A prepackaged bankruptcy or “prepack” is generally considered a tool for dealing with holdouts (McConnell and Servaes, 1991; Tashjian, Lease, and McConnell, 1996), because, unlike traditional Chapter 11, “prepacks” are typically not used to restructure operations, but rather they are used to put a prearranged plan into effect. Thus, if loans held by CLOs are more difficult to restructure due to more severe holdout problems, then we would expect the likelihood of a “prepack” versus an out of court restructuring to be higher when the firm relies heavily on loans held by CLOs. Consistent with more severe holdout problems, we find that reliance on loans held by CLOs is positively and significantly related to the likelihood of prepackaged bankruptcy.

Finally, we examine the role of past lending relationships with traditional banks in the restructuring process. For example, traditional bank loans may be relationship-based loans and relationship lenders may be more willing to restructure their claims to preserve relationship rents. Thus, we examine whether a past lending relationship with the lead arranger (or sole lender) is related to the likelihood of a restructuring and whether the impact of relationships varies with whether the loan is syndicated. As Sufi (2007) and Dass, Nanda, and Wang (2012) point out, in syndicated loans, incentive conflicts between the lead arranger and syndicate members may arise when the lead arranger has an ongoing relationship with the borrowing firm, which makes restructuring syndicated loans more difficult. Consistent with this argument, we find for syndicated loans that the likelihood of a restructuring is

[3] Using data from the 1980s and 1990s, Asquith, Gertner, and Scharfstein (1994), Franks and Torous (1994), and James (1995, 1996) examine the role that banks play in debt restructurings involving firms with public debt.

[4] For example, according to Bord and Santos (2012), bank ownership of term loans at origination declined steadily from roughly 90% in 1988 to 45% in 2007. Over the same time period, the ownership of CLOs and asset management firms increased from zero to 15.5% and 13.6%, respectively. Also, according to Thomson Reuters Loan Pricing Corporation's Dealscan database, the percentage of loan facilities (by number) that were syndicated increased from 65.4% in the 1987–1994 period to 99.1% in the 2006–2011 time period.

[5] To facilitate comparison of our results to those of GJL, we include insurance companies as traditional bank lenders (this is the measure that GJL use). Since there are very few insurance company lenders, our findings are similar if we define bank loans even more narrowly to include only loans from commercial banks.

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