



The value of creditor control in corporate bonds[☆]



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ABSTRACT

This paper introduces a measure that captures the premium in bond prices that is due to the value of creditor control. We estimate the premium as the difference in the bond price and an equivalent synthetic bond without control rights that is constructed using credit default swap (CDS) contracts. We find empirically that this premium increases as firm credit quality decreases and around important credit events such as defaults, bankruptcies, and covenant violations. The increase is greatest for bonds most pivotal to changes in control. Changes in bond and CDS liquidity do not appear to drive increases in the premium.

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1. Introduction

Creditors play an increasingly active role in corporate governance as credit quality declines. For example, covenant violations trigger a shift in control rights to creditors, giving them the ability to intervene in managerial decisions (Chava and Roberts, 2008; Roberts and Sufi, 2009; Nini, Smith, and Sufi, 2012). Distressed debt investors frequently accumulate large positions in a firm's bonds in

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pre- and post-default periods (Hotchkiss and Mooradian, 1997; Jiang, Li, and Wang, 2012; Ivashina, Iverson, and Smith, 2016). As firms become seriously distressed, creditor control can affect managerial decisions in a way that impacts the value of debt claims, the form of a restructuring that could occur, and the distributions to creditors in the event of a restructuring. In many cases, a default leads to a change in control in which creditors become the new owners of a firm through distributions of stock in a restructuring.

While the shift in control from shareholders to creditors before and during credit events such as defaults is well established in the theoretical literature, empirical evidence showing the importance of creditors in firm governance is scarce.¹ In this paper, we take a new approach and analyze the impact of this shift in control on the pricing of a firm's bonds. We propose a measure of the premium in bond prices that is related to creditor control.

We estimate this premium as the difference in the bond price and an equivalent synthetic bond without control rights that is constructed using credit default swaps (CDSs). The main insight for the methodology is that CDS prices reflect the cash flows of the underlying bonds, but not the control rights.² Our method is similar in spirit to Kalay, Karakaş, and Pant (2014), in which the control premium in equity is measured by taking the difference between the stock and the synthetic non-voting stock constructed using options. For comparison across time and companies, we measure the premium as a percentage of the bond price. The premium we introduce captures the marginal value of control in a bond until the bond matures or, in the case of a payment default or bankruptcy, until the CDS contracts for that issuer settle, typically within two months following the default. Because bonds can continue to exist and trade after a CDS settlement, our measure is a lower bound for the control premium.

The premium we construct can be mapped into the CDS-bond basis examined in a number of studies starting with Longstaff, Mithal, and Neis (2005). Our measure is based on price differences (rather than the difference in CDS and bond yield spreads), which has an interpretation that corresponds more naturally to a control premium that is the subject of extensive literature on corporate control. In contrast to our work, prior studies of the determinants of the CDS-bond basis focus on whether the basis can be explained by measures of bond and CDS liquidity, as well as other non-control-related frictions such as counterparty credit risk or funding costs. We argue that beyond liquidity differences or other frictions, deviations from the no arbitrage relation between CDS and bond prices reflect the value of control. We expect the premium to increase and

to have a positive value as credit quality deteriorates, because the probability that control will shift to bondholders increases. Further, around events such as defaults in which control rights are especially valuable, we expect the premium to be higher the more contentious the contest for control, particularly for bonds that are pivotal to a change in control.

Our sample consists of 2,020 publicly traded bonds of 963 US companies that have both price data available from the Financial Industry Regulatory Authority's (FINRA) Trade Reporting and Compliance Engine (TRACE) and concurrent CDS quote data available from Markit in the period from 2002 to 2012. We first examine the relation between our premium and credit ratings in a panel regression, which includes numerous bond and CDS liquidity measures and bond characteristics as control variables as well as firm and time fixed effects. We find that the premium is close to zero for bonds of high credit quality firms, but it monotonically increases as the credit rating declines for non-investment grade firms. The increase in the premium with lower credit quality is more pronounced for bonds that have had large rating downgrades since the issuance of the bond.

We further investigate the behavior of the premium in three settings in which control rights shift to creditors: defaults, bankruptcies, and covenant violations. We examine the premium in the time period leading up to default for 77 firms in our sample.³ The premium monotonically increases toward the default, on average increasing to approximately 3% one year before default and over 6% by the time of default. We consider several measures of bond and CDS liquidity and show that they cannot explain the observed time series behavior of the premium. In fact, the premium starts to increase well before observed changes in liquidity. Among three CDS liquidity measures we use (number of quote providers, number of quotes across CDS maturities, and number of days with active quote changes), only the number of quote providers suggests a slight decrease in liquidity near the default, while the other two measures remain unchanged. We show the changes in four bond liquidity measures (round-trip costs, Amihud measure, volume, and number of transactions), as well as a measure of price pressure based on Feldhütter (2012). The round-trip cost and Amihud measures increase in the year leading to default. However, a decrease in bond liquidity should lead to a lower measured premium of bond over CDS implied prices. Bond volume increases for a smaller window around the default, as do the number of transactions and buying pressure. The higher level of trading activity likely reflects an active market for trading distressed securities and, consistent with Ivashina, Iverson, and Smith (2016), a concentration in ownership of debt claims around the default.

We next focus on the narrower subset of 53 defaulting firms that file for Chapter 11 bankruptcy. Bondholder intervention is particularly important in the period leading up to the bankruptcy filing and early in the Chapter 11 case.

¹ Shleifer and Vishny (1997) argue that both creditors and equity holders exert influence over managerial decisions as the firm value declines. Several legal scholars including Baird and Rasmussen (2006) and Ayotte and Morrison (2009) have more recently made similar arguments.

² The unbundling of the economic (cash flow) rights and contractual control rights that has become possible through credit derivatives has also led to concerns of an empty creditor problem, in which a debtholder obtains insurance against default but otherwise retains control rights in and outside bankruptcy. See, e.g., Hu and Black (2008), Bolton and Oehmke (2011), and Subrahmanyam, Tang, and Wang (2013).

³ The default subsample consists of firms that restructure both out of court and in bankruptcy.

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