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How do Firms Respond to Empty Creditor Holdout in Distressed Exchanges?

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Abstract

Empty creditors—bondholders hedged with Credit Default Swaps (CDSs)—face incentives to holdout from "Distressed Exchanges" (DEs) of debt because the CDS hedge alters their payoffs to favor bankruptcy. We show using detailed data on DEs that firms respond to this holdout problem by targeting junior bondholders who are more likely to tender than senior bondholders. Furthermore, we show that doing so allows them to successfully reduce debt through the DE and avoid bankruptcy. Our evidence underscores the importance of the firm's response to the holdout problem in understanding the role of empty creditors in distress resolution.

Keywords: Credit Default Swaps (CDSs), Empty Creditors, Debt Restructuring, Distressed Exchange, Bankruptcy, Holdout Problem, and Financial Distress.

JEL Classification: G10, G30, G33, G34.

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