International Review of Economics and Finance 35 (2015) 278–291

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

Bank relationships and the likelihood of filing for reorganization

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ARTICLE INFO

Article history:
Received 8 August 2013
Received in revised form 10 October 2014
Accepted 14 October 2014
Available online 22 October 2014

JEL classification:
G21
G33

Keywords:
Bank relationship
Reorganization
Financial distress
Duration analysis

ABSTRACT

This paper examines the effects of bank relationships on the likelihood and duration of the decision to file for reorganization for a sample of Taiwanese firms in default. We find that bank relationships significantly influence the likelihood and duration of a firm's decision on filing for reorganization. Firms with strong bank relationships exhibit significantly decreased likelihood of filing for reorganization and increased length of time needed for making the decision. The findings suggest that in a bank-oriented financial system where banks are the dominant providers of capital, bank relationships better enhance informational advantages for banks and reduce coordination problems among banks, which limits firm filings for costly reorganizations.

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1. Introduction

The special property of bank–firm relationships has been the subject of extensive theoretical and empirical research in finance (Boot, 2000; Elyasiani & Goldberg, 2004; Ongena & Smith, 2000). In particular, existing empirical work has been aimed primarily at establishing and estimating the effect of the bank relationships that may benefit private mechanisms for resolving financial distress (Brunner & Krahnen, 2008; Couwenberg & de Jong, 2006; Jostarndt & Sautner, 2010). However, little is known about how bank relationships affect the likelihood of distressed firms' decision on filing for formal reorganization.

In practice, a firm in financial distress can privately renegotiate outstanding debt in an out-of-court workout or file for formal reorganization to resolve its distress through an in-court proceeding. However, to protect the firm from creditor harassment while it tries to reorganize, most bankruptcy codes impose an automatic stay that prevents creditors from collecting on their debt or foreclosing on their collateral until the firm leaves bankruptcy (Gilson, John, & Lang, 1990). Indeed, the central question addressed here is: At any given level of financial distress, why do some firms file for reorganization while others do not file? In addition, why may some prefer immediate filing while others may be content to wait? The scholarly literature has devoted comparatively more attention to the cost of reorganization (Hotchkiss, John, Mooradian, & Thorburn, 2008), the potential stigma of bankruptcy and its impact on managerial employment capital (Gilson et al., 1990), and the relatively low incidence of successful reorganization in bankruptcy (Moulton & Thomas, 1993). More recently, another stream investigating post-bankruptcy issues has documented that financial distress is sometimes resolved through formal reorganization procedures and may therefore be explained by bargaining inefficiencies

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http://dx.doi.org/10.1016/j.iref.2014.10.007
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such as asymmetric information (Claessens, Djankov, & Klapper, 2003; Shibata & Tian, 2012) or coordination problems among lending banks (Brunner & Krahnen, 2008; Jostarndt & Sautner, 2010). Consequently, one can expect that the asymmetry of information about the true value of distressed firms and the hold-out problem (due to coordination issues) among creditor banks may result in debt renegotiation failing. Given this, the duration of decision-making and the filing for reorganization decision itself can be expected to reflect the balance of bargaining power between the debtor and its creditor banks. Therefore, additional research into the dynamics of creditor–firm relationships is necessary (Donoher, 2004), including investigation of the impact of bank relationships on the likelihood of filing for reorganization and the length of time needed for filing.

From the firm's perspective, strong bank relationships are generally considered valuable assets because they lower the cost and increase the availability of credit as a reduction in the costs of financial distress due to implicit risk-sharing agreements (Berger & Udell, 1995). However, when a distressed firm opts to file for reorganization, it means that the firm elects an instant termination of bank relationships. This implies that the likelihood of a private settlement is limited because banks are not willing to assist firms in restructuring without significant information advantages. Therefore, in order to prevent dissipation of existing benefits of bank relationships, the firm's managers must take strong corrective measures.

To address the firm's decision on filing reorganizations, we constructed two measures (i.e., the existence of bank relationships and number of bank relationships) and a duration analysis, focusing on how bank relationships affect the likelihood and duration of filing for reorganization in the bank-dominated Taiwanese financial market. Using a sample of 269 distressed debt restructuring attempts by publicly listed firms from Taiwan between 1995 and 2008, we study the relationship between the degree of bank relationships and whether a reorganization petition is filed in two ways. First, we assess whether firms are less likely to file for reorganization when the bank relationships are stronger. Second, we examine whether firms delay filing for reorganization when bank relationships are stronger.

Our main findings are that bank relationships significantly influence the likelihood and duration of the firm's decision to file for reorganization due to the mitigation of information asymmetry and reduced coordination problems among banks. This result suggests that the mitigation of conflicts due to information asymmetry and coordination problems significantly delays filing for reorganization, which in turn impedes filings for costly formal reorganizations. Our results are robust regardless if the bank relationship is proxied by either the loan amount or relationship length.

The remainder of the paper is organized as follows. Section 2 gives an overview of the literature and develops the hypotheses. Section 3 discusses the legal framework of the Taiwanese reorganization law. Section 4 describes the data and sample selection. Section 5 shows the main empirical results. Section 6 concludes.

2. Reorganization, bank relationship and hypotheses

Several papers have examined how corporate governance and capital structure characteristics determine the likelihood of filing for reorganization (Berström, Eisenberg, & Sundgren, 2002; Blazy & Chopard, 2012; Claessens et al., 2003; Donoher, 2004; Halpern, Kieschnick, & Rotenberg, 2009). Berström et al. (2002) found a negative correlation between how well-secured banks and other institutional lenders are and the likelihood of a confirmed reorganization. Blazy and Chopard (2012) documented that a reduction in the influence of secured creditors on the reorganization process is likely a means to promote reorganization of the bankrupt firm. Claessens et al. (2003) found that informational advantages or preferential sources of credit associated with internal markets encourage out-of-court renegotiations and limit the use of formal bankruptcy procedures for bank-owned and group-affiliated firms in East Asian countries. Donoher (2004) investigated the reorganization decision using a matched-pair sample of 110 filing firms and 110 nonfiling firms between 1990 and 1996. The results indicate that firms with high levels of outside equity holdings and current indebtedness seek reorganization in comparatively good financial conditions. Conversely, firms with high levels of inside equity ownership and secured indebtedness ostensibly do not do so. Following the evidence, Donoher (2004) suggested a need for additional research into the creditor–firm relationships and the prospect of inter-creditor conflict in the firm's decision to file for reorganization. Nonetheless, despite these valuable contributions to the literature, the implementation of a distressed firm to determine the likelihood of filing for reorganization may raise certain concerns for the bank–firm relationships.

More recently, Chi (2010) investigated the impacts of three different types of final resolutions of the reorganization plan (i.e., reorganization ratification, out-of-court settlement, and filing dismissal) on the shareholder wealth of the filer's better informed bank, i.e. the lead lending bank (LLB).[2] Results reveal that LLBs have the largest (least) negative stock returns in response to the announcement of filing dismissal (reorganization ratification), and indicate that bank relationship variables, loan amount and number of lending banks, are significantly negative in explicating the valuation effect on the filer's LLB. Huang, Huang, and Lin (2013) investigated the determinants of the choice between debt renegotiation and reorganization filing. Their empirical results indicate that the initial choice between debt renegotiation and reorganization filing is closely associated with the firm's bank relationships; however, this varies according to the relative bargaining power of firms and their banks, with the likelihood of a successful debt renegotiation increasing with the bargaining power of the distressed firm. In short, Chi (2010) focused on the final resolutions of the reorganization plan. Alternatively, Huang et al. (2013) investigated how firms react to financial distress given their greater bargaining strength in a debtor-friendly bankruptcy system. In comparison, this study seeks to examine how the firm's decision on filing for reorganization is affected by bank–firm relationships in a bank-dominated financial system like

[2] Chi (2010) located the LLB for 2876 loan transactions by calculating and screening the largest loan share to the borrower among all lending banks.

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