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The ownership and trading of debt claims in Chapter 11 restructurings ☆

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ABSTRACT

Using a novel data set that covers individual debt claims against 136 bankrupt US companies and includes information on a subset of claims transfers, we provide new empirical insight regarding how a firm's debt ownership relates to bankruptcy outcomes. Firms with higher debt concentration at the start of the case are more likely to file prearranged bankruptcy plans, to move quickly through the restructuring process, and to emerge successfully as independent going concerns. Moreover, higher ownership concentration within a debt class is associated with higher recovery rates to that class. Trading of claims during bankruptcy concentrates ownership further, but this trading is not associated with subsequent improvements in bankruptcy outcomes and could, at the margin, increase the likelihood of liquidation.

1. Introduction

The ownership structure of corporate debt is potentially a key factor affecting the cost of financial distress. However, past studies have been hampered by the fact that observing the ownership of debt claims is difficult. We overcome this obstacle by using claim-level holdings and trading data on bankrupt firms collected electronically by claims administration companies.[1] For 136 large US bankruptcy cases filed between July 1998 and March 2009, these data identify the holder of each claim or the name of a custodian, the amount of the claim, information on the claim type, and, for a subset of claims, ownership transfers that occur during the bankruptcy process. We use these

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[1] The phrase "bankruptcy claim" is a broader concept than "security," as it can include any of the firms' liabilities, interests, or other rights-to-payment. In what follows, we use the terms "claim holders" and "creditors" interchangeably.

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data to study the ownership structure of firms that have filed for bankruptcy, how ownership changes during bankruptcy, and ultimately, how ownership structure influences Chapter 11 outcomes (our data set does not include private workouts).

We collect claim-level holdings data at two points during the bankruptcy: (1) at the start of the case when the debtor files its Schedules of Assets and Liabilities ("Schedules"), and (2) near the end of the case when votes are tabulated for the debtor's Plan of Reorganization or Plan of Liquidation ("Plan"). We observe holdings across the entire capital structure for each sample firm in the Schedules and for the subset of all voting creditors at the time vote tabulations are submitted for a Plan. The second snapshot allows us to see claims holdings for 75% of the original claims, weighted by face value. Between the two snapshots, our data cover 71,358 different creditors in the 136 bankrupt firms.

We show that ownership concentration, measured as the share of total claims owned by the ten largest creditors, is strongly associated with bankruptcy outcomes. When ownership is highly concentrated at the bankruptcy filing, cases are more likely to be filed as prearranged or prepackaged bankruptcies, in which much of the negotiation among creditors is completed prior to entering bankruptcy. Subsequently, the bankruptcy process moves more quickly than it does in cases that are not prearranged.[2] Creditor concentration is also positively related to the speed at which traditional (non-prearranged) Chapter 11 restructurings occur and to the likelihood that firms reorganize as independent going concerns (as opposed to being sold or liquidated). Finally, we show that classes of debt that are more concentrated within a firm's capital structure have higher recovery rates at bankruptcy exit than classes that are less concentrated. To the extent that faster bankruptcy resolution and survival as an independent firm are indicators of a more efficient outcome, our results suggest that more concentrated capital structures are associated with better restructuring outcomes.

Modern debt markets allow for extensive trading in the claims of distressed firms, including not only bonds and bank debt, but also trade credit and lease, tax, insurance, and derivative claims. Our data set captures trading during bankruptcy cases through disclosures of Rule 3001 (e) transfers, composed chiefly of trade credit, canceled leases, and debt instruments not registered with the Securities and Exchange Commission (SEC) or a loan syndicate. We find that Rule 3001(e) trading increases creditor concentration during bankruptcy. For example, by the end of the bankruptcy process, firms in the top tercile of trading intensity—measured as total in-bankruptcy trading volume scaled by the total amount of claims outstanding—have voting claims that are 16 percentage points more concentrated than firms in the bottom tercile, which is a difference of nearly one standard deviation. Many of these increases in ownership concentration occur as the result of consolidation of claims through purchases from trade creditors. (As a group, trade creditors hold an average of 22.5% of the total claims volume in a bankrupt firm at the time of the filing and 24.1% of the claims volume entitled to vote on a Plan.)

While creditor ownership concentration at the start of the case is positively related to the ability to quickly and successfully reorganize, we find that further increases in creditor concentration are associated with a higher likelihood that the restructuring ends in the liquidation of the firm. This finding is robust under a variety of specifications and to an instrumental variables approach that uses characteristics of trade credit [a proxy for the propensity to trade 3001(e) claims] to instrument for creditor ownership concentration at bankruptcy exit. Although we cannot directly pin down the reasons for the trade-related increase in the propensity to liquidate, we posit that some investors could take defensive hold out positions that reduce the chance of successful reorganization. This is consistent with the theoretical work by Gertner and Scharfstein (1991).

Our study is motivated by the theories of Diamond (1991), Rajan (1992), Berglöf and von Thadden (1994), and Bolton and Scharfstein (1996), which argue that debt ownership structure has the potential to influence renegotiation costs in distressed restructurings. In this regard, our paper contributes to research dating back to Gilson (1990), Gilson, John, and Lang (1990), Brown, James, and Mooradian (1993), Asquith, Gertner, and Scharfstein (1994), and James (1996), who examine how the amount of bank debt versus public bonds in a capital structure impacts distressed workouts. Our paper extends this literature by assembling a fuller picture of the creditors of distressed companies and showing that overall ownership concentration is associated with more efficient bankruptcy outcomes.

Our paper is the first to show that claims trading during bankruptcy proceedings also influences ownership concentration. Our finding that further ownership consolidation in bankruptcy is indicative of a holdout problem, as well as our description of the prominent role of active investors as buyers of 3001(e) claims, adds to work by Hotchkiss and Mooradian (1997) and Jiang, Li, and Wang (2012), who study the involvement of hedge funds in bankrupt firm restructurings. We confirm that active investors impact bankruptcy outcomes, but we also show a specific channel through which active investors influence the bankruptcy process.

The rest of the paper proceeds as follows. Section 2 describes the data. Section 3 presents the distribution of debt claim ownership by creditor type across the bankrupt firms in our sample and analyzes the observed credit trading activity during bankruptcy. Section 4 analyzes the effects of ownership concentration on bankruptcy outcomes and discusses how trading during bankruptcy relates to both creditor concentration and bankruptcy outcomes. Section 5 concludes.

[2] Although this result is intuitive, strictly speaking, we cannot establish a causal link between ownership concentration and prearranged filing because our identification is based on trading during bankruptcy, and prearranged reorganization plans by definition are already set at the time of a bankruptcy filing.