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Acquisitions of bankrupt assets

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ABSTRACT

Buyers of bankrupt assets could be penalized because of uncertainty about the value of such assets given their poor performance, and the absence of a guarantee offered by bankrupt estates. On the other hand, they could be rewarded if imperfections in the market for bankrupt assets result in deep discounts. In this paper, we assess 314 acquisitions of bankrupt assets over the period 1985–2006. We find that firms that acquire bankrupt assets experience significant positive valuation effects, suggesting that the market for bankrupt assets is imperfect. Second, the valuation effects are especially favorable when the acquisition is only of selected assets, and when the buyer is in the same industry as the bankrupt firm. No evidence of long run abnormal returns (above and beyond the initial valuation effects) is found for firms that acquire bankrupt assets.

1. Introduction

A financially distressed firm (i.e. a debtor firm) may file a voluntary petition for bankruptcy with a bankruptcy court in an attempt to resolve its financial problems. Alternatively, creditors of the debtor firm may file an involuntary petition when they believe that so doing enhances their interests. A corporate bankruptcy filing falls under one of two chapters of the Bankruptcy Code: Chapter 7 (liquidation) or Chapter 11 (reorganization).[1] In Chapter 7, the assets of the debtor firm are liquidated and the proceeds are distributed among creditors based on the absolute priority rule. In Chapter 11, the

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[1] For an introduction to corporate bankruptcy, please refer to www.sec.gov/investor/pubs/bankrupt.htm.

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debtor firm is temporarily protected from its creditors while it seeks to formulate a reorganization plan. While Chapter 7 involves an outright liquidation of all of a bankrupt firm's assets, debtor firms may also sell part of their assets in Chapter 11. Assets in bankruptcy experience a cleansing process in which directly owned assets are sold out of bankruptcy free and clear of any prior liens, encumbrances, or other charges.

Jensen (1991) argues that sales of bankrupt assets represent an important mechanism to induce their efficient redeployment. Asquith, Gertner, and Scharfstein (1994) and John and Ofek (1995) find that asset sales form an important part of debt restructuring plans. Gilson (1990) and Brown, Christopher, and Mooradian (1994) show that creditors often pressure distressed firms to sell assets in order to pay down debt (see also Rajan, 1992, and Diamond, 1993). Such selling may also result in a fire sale of the bankrupt firm's assets (see Aghion & Bolton, 1992, and Aghion, Hart, & Moore, 1992). The selling price of bankrupt assets is further reduced when a bankrupt firm offers concessions to bidders. Clark and Ofek (1994) find that 32% of bidders obtain concessions from various bankrupt target's claim holders.

The empirical evidence on the valuation effects for buyers of bankrupt assets is mixed. In a study of 38 takeovers of distressed firms, Clark and Ofek (1994) report that such takeovers are generally not successful. However, Bartunek, Madura, and Tucker (1995) find that firms announcing acquisitions of bankrupt targets on average experience favorable wealth effects. Similarly, Hotchkiss and Mooradian (1998) find positive abnormal stock returns to the bidder on average in response to 55 acquisitions of bankrupt firms. Thus, the evidence is mixed, and this could be due to the limited samples assessed in the past.

We re-examine the wealth effects of acquiring bankrupt assets based on a larger and more recent sample of acquisitions announced between 1985 and 2006. We also explore why the wealth effects vary among the buyers, and assess the long-term post-acquisition performance of buyers of bankrupt assets. In sharp contrast with the prior literature, we find that firms that acquire assets of bankrupt firms experience positive and significant valuation effects. Second, the valuation effects are especially favorable when the acquisition is of selected assets only, and when the buyer is in the same industry as the bankrupt firm. Third, firms that acquire assets of bankrupt firms do not experience significant abnormal returns in the long run.

The rest of the paper proceeds as follows. In Section 2, we present our hypotheses. In Section 3, we present the data. In Section 4, we present the methodology. We present and discuss the results in Section 5, and we conclude in Section 6.

2. Hypotheses

Our hypotheses focus on the valuation effects of acquisitions of bankrupt assets both at the time of the announcement and over the long-run period post-acquisition. We also look at the factors that may explain the variation in valuation effects among buyers.

2.1. Valuation effects in response to bids for bankrupt assets

Information known to managers of the debtor firm may be much greater than that available to potential buyers of the bankrupt assets. The market may penalize acquirers of bankrupt assets if buyers face a "lemons problem" (see Akerlof, 1970, and Hotchkiss & Mooradian, 1998) in which they do not realize the limitations of the assets until after the assets are purchased. By this time, the debtor firm does not exist, and the buyers may have no recourse. Moreover, bankrupt estates do not and cannot provide representations and warranties which continue after they cease to exist.

However, several counters could yield favorable effects for buyers. First, if buyers of bankrupt firms face a "lemons problem," then they will likely require a significant discount from what otherwise would have been the fair market value/price before purchasing the bankrupt assets. Second, the sale of assets from a bankrupt company would also take into account the damaged nature of the assets that are sold from the estate. Hotchkiss and Mooradian (1998) find that bankrupt targets are, on average, purchased at a 45% discount relative to prices paid for non-bankrupt targets in the same industry. Pulvino (1998) finds that sales of aircraft under conditions of distress on average produce prices that