Resolution of Corporate Financial Distress: An Empirical Analysis of Processes and Outcomes

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In situations of default or financial distress, there are two primary resolution processes that a firm can pursue: a private resolution, by renegotiating existing claims, or a public resolution, by utilizing legal bankruptcy channels. When a private arrangement among a firm’s stakeholders cannot be reached, firms in the United States file for protection under the bankruptcy code and are placed under court supervision. Bankruptcy is usually settled with a court-approved rehabilitation scheme within about one-and-a-half years of filing. Whether public or private, these restructurings allow for one of the following outcomes: emergence as an independent entity, acquisition by another firm, or liquidation of assets and the distribution of proceeds to stakeholders.

Analysis of the resolution of financial distress provides useful information to portfolio managers who hold distressed securities. Following the recent financial crisis, investment in distressed debt by hedge funds and private equity firms has increased significantly (Shadab [2009]). Based on analysis of a survey of 364 institutional investors, Harner [2008] presented evidence that 20% of portfolio managers have investments in distressed debt, and an overwhelming majority of those intend to maintain or increase their distressed debt holdings. Due to the structural protections built into the resolution process, portfolio managers increasingly find that investing in distressed debt securities is an alternative source for generating returns that does not unduly increase risk. Harner’s analysis also shows that most managers have a relatively short horizon when investing in distressed debt.

Clearly, many factors affect the resolution process and the resolution outcome including firm characteristics, firm performance, macroeconomic factors, and market factors. Because firms in financial distress share similar characteristics (i.e., declining revenues, earnings, assets, and equity), it is more difficult to differentiate among them and classify the final outcome versus predicting financial distress among all firms. Consequently, in the prior finance literature, the problem of predicting bankruptcy resolution has not been studied as extensively as that of predicting financial distress. Our research studies both the resolution and outcome of financial distress in an econometrically rigorous fashion with an application to a current dataset of public defaults. Exhibit 1 presents our modeling of the resolution processes and outcomes, and provides the number of firms within our data sample for each category. Although, in general, there are six paths that a financially distressed firm can follow, not surprisingly we do not observe liquidation as an outcome when a firm follows a private resolution process; see Exhibit 1.

Portfolio managers’ decisions to invest or disinvest in distressed securities will depend on their forecast of the path a firm may take.