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Bankruptcy outcomes: Does the board matter?

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ABSTRACT

We examine the association between board composition and bankruptcy outcomes. Preliminary analyses provide no evidence that the proportion of outside directors is significantly associated with the likelihood that a Chapter 11 firm liquidates. Further analyses indicate, however, that the relation between the proportion of outside directors and bankruptcy outcomes is a function of the outside directors' ownership. More specifically, we find that the association is positive when outside director ownership is low and negative when it is high. The overall evidence supports the notion that a one-size-fits-all approach to corporate governance is likely to result in suboptimal board structures and hinder firms' strategies for dealing with poor performance.

1. Introduction

The recent failures of many large U.S. corporations have generated considerable interest in corporate bankruptcy and corporate governance among regulators and academics. This study examines the interaction between board composition, outside director ownership, and bankruptcy outcomes. The extant literature generally presumes that outside directors are likely to be more effective monitors of management and to better serve the interests of shareholders than inside directors (Demsetz, 1983; Fama, 1980). Accordingly, Daily (1995) provide some evidence that bankrupt firms with lower percentages of outside directors are more likely to liquidate. The early studies that suggest that outside directors would better represent the interests of shareholders envision a world where ownership and control are effectively separated. However, the last two decades have seen a substantial increase in managers' and directors' ownership, creating the need to consider the effects of ownership on directors' effectiveness.[2]

The notion that outside directors would generally have a negligible marginal effect on operating results and yet a positive effect on bankruptcy outcome suggests that outside directors could be more effective when the survival of a firm is at stake. However, such a conjecture appears somewhat counterintuitive. First, the monitoring role of outside directors should be less important for a bankrupt firm than for a going concern because, among other things, the ability of a bankrupt firm's managers to extract rents is substantially constrained. Second, outside directors generally have less at stake and, hence, weaker incentives to avoid liquidation than insiders. Therefore, it is not obvious why, on average, the odds of liquidation would decrease in the proportion of outside directors. We hypothesize that, if outside directors affect bankruptcy outcomes, the effect is likely to be associated with their stake in the firm.

Using a sample of 152 bankruptcy filings from 1994 to 2004, we first find no evidence that the proportion of outside directors is significantly associated with the likelihood that a Chapter 11 firm liquidates. Further analyses indicate, however, that the relation between the proportion of outside directors and bankruptcy outcomes is a function of the outside directors' ownership. The probability of liquidation significantly decreases in the proportion of outside board members, but only when the outsiders' stock ownership in the firm is high. In contrast, we find that the probability of liquidation significantly increases in the proportion of outside directors when the outsiders' ownership is low. These results are robust to controlling for the association between the proportion of outside director and firm size, potential strategic liquidations, and the association between recent increases in outside director ownership and heightened pressure on outside directors to perform.

Extant studies generally fail to document an association between firm performance and board quality, and generally conclude that board structure is irrelevant. Our findings indicate, however, that

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[1] Dahlia Robinson gratefully acknowledges the research support of the KPMG Foundation.
[2] In an effort to address stockholders' concerns about the proper alignment of director and shareholder interests, many boards have recently implemented stock ownership guidelines and holding requirements for directors. For example, Merrill Lynch, in its 2006 proxy statement, maintains that "the equity component of director compensation serves to further align the non-management directors with the interests of our shareholders." Many firms actually have well-defined policies that require that directors hold a minimum number of shares. In its reports on stock ownership policies by Fortune 250 firms, Frederick W. Cook & Co Inc. observes an increasing trend in the number of firms that have such guidelines. The reports find, for instance, that 32% (49%) of the Fortune 250 firms had formal stock ownership guidelines for non-employee directors in 2002 (2003), an increase of 46% (53%) over the prior year. See http://www.fwcook.com/alert_letters/FWC_Stock_Ownership_09.04.pdf and http://www.fwcook.com/alert_letters/FWC_Stock_Ownership_09.03.pdf.

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board structure could be relevant and that the failure of prior studies to isolate the effects of outside directors in some studies could be due to insufficient controls for the outsiders' stake in the firm. The results also support the notion that a one-size-fits-all approach to corporate governance is likely to result in suboptimal board structures and hinder firms' strategies for dealing with poor performance and are consistent with Boone, Field, Karpoff, and Raheja's (2007) conclusion that economic considerations determine board structures.

The remainder of the study is organized as follows. The next section presents our hypothesis development. Section 3 discusses the research design. Section 4 presents some descriptive statistics. The results are reported in Section 5. The study concludes in Section 6.

2. Expected association between liquidation and proportion of outside directors

The ability of a board to recommend appropriate actions and to monitor the implementation of these recommendations is likely to determine the financial position of the firm and the outcome of a bankruptcy proceeding. Although the court and creditors are involved in the governance of bankrupt firms, in general, managers and directors continue to exercise substantial control and, allegedly, often wield too much power in the Chapter 11 bankruptcy proceeding (see Bradley & Rosenzweig, 1992a, 1992b). Elson, Helms, and Moncus (2002) suggest, for instance, that bankrupt firms rely heavily on their boards to effectively accomplish the necessary reforms during the Chapter 11 process. They further contend that "the nexus between monitoring and performance becomes most relevant at the time a corporation attempts to reemerge from bankruptcy" (p. 1926). The board is involved in developing and monitoring the implementation of both the business plan and the reorganization plan, and retains the power to replace the managers (LoPucki and Whitford (1993). Bankruptcy judges also rely on the effectiveness of a firm's overall governance when approving reorganization plans. The directors' power can be challenged in court; however, bankruptcy law does not allow creditors to take control of the reorganizing firm from the board, nor does it allow shareholders to elect directors during reorganization. Substitution of a court-appointed trustee for the board is rare (LoPucki, 2004). See LoPucki and Whitford (1993) for an extensive discussion of corporate governance in bankruptcy proceedings.

Notwithstanding the potential effect of corporate boards on bankruptcy outcome, the contention that outside directors would reduce the likelihood of liquidation remains puzzling given that outside directors generally have much lower stakes in the survival of a firm than managers, who often have both their financial and human capitals linked to the firm. When a firm liquidates, managers lose not only their financial investments but also their employment. Furthermore, the stigma attached to bankruptcy is likely to impede their abilities to subsequently find suitable employment (Gilson, 1989). As Fama and Jensen (1983a) argue, outside directors are generally key decision-makers at other organizations and are therefore concerned about their reputations in the managerial labor market. Nonetheless, in general, the consequences of liquidation are likely to be less severe for outside directors than for managers.

Based on the aforementioned considerations, we hypothesize that, if outside directors affect the likelihood of liquidation, the effect is likely to be associated with the outsiders' stake in the firms. We posit that, given that managers typically have higher stakes in the outcome of the bankruptcy process than outside directors, in general, the likelihood of liquidation should decrease with the proportion of executives on the board. However, as the outsiders' stake in the firm increases, and with the firm's survival at risk, outsiders could gain more power and increase their involvement in the governance of the firm. Thus, the effect of outside directors could then increase to a point where it becomes optimal to have more outsiders on the board.

We focus on outside director ownership—instead of managerial ownership or some other forms of outside director interest—because, contrary to managers who generally have their entire careers linked to the outcome of the bankruptcy process, independent outside directors often face only some reputation cost and the loss of their ownership. Therefore, the cross-sectional variation in ownership better captures the variation in outside directors' incentives than the variation in managerial incentives. We also conduct the analysis using both outside director ownership and the ratio of outside director ownership to managerial ownership. However, we rely more on outside director ownership because it is presumably a better proxy for outside directors' power and incentive to affect bankruptcy outcomes than the ratio of outside director ownership to managerial ownership. The ratio gives too much weight to the outsiders' relative stakes when their ownership is low but higher than the managers' ownership and too little weight when their ownership is high but lower than the managers' ownership. For instance, if the outside directors collectively own 0.3% of the firm's equity and the managers own 0.1%. Then, the outsiders would appear to have three times as much interest in the firm as the managers. In reality, such low ownership levels are likely to offer little motivation to either the managers or the directors. However, because of the human capital the managers have invested in the firm, they are likely to have strong incentives in the outcome of the bankruptcy proceeding even though their ownership is low. Therefore, when outsider ownership is low but higher than managerial ownership, the ratio tend to exaggerate the outsiders' relative stake. Thus, we consider the outsiders' ownership a better, albeit not a perfect, measure of their power and incentive to affect bankruptcy outcomes.

It might appear that, if a board could prevent liquidation, then it should have been able to prevent the firm from getting into distress in the first place. However, we do not know what would have happened if the firm had a different board. The fact that a firm files for bankruptcy does not necessarily mean that its board was not effective. More importantly, the board that is in place at the time of bankruptcy filing is not necessarily the board that presided over the decline on the firm. Our analysis is limited to examining the association between board composition at the time of bankruptcy filing and bankruptcy outcomes. More specifically, given that a firm files for bankruptcy, we want to determine whether and how the composition of the board in place at the time of the filing affects the probability of liquidation.

Recent studies suggest that, given that a firm is facing bankruptcy, the Chapter 11 process is generally the preferred outcome from a shareholders' standpoint.[3] Kalay, Singhal, and Tashjian (2007), for instance, find that, on average, firms experience significant improvements in their operating performance during the Chapter 11 bankruptcy process. Barniv, Agarwal, and Leach (2002) also report that, on average, bankrupt firms that are acquired and those that reorganize experience cumulative abnormal returns of 155% and 137%, respectively, between the filing and the final resolution. However, liquidation is not always the least favorable outcome; there are cases where liquidation could be in the best interest of shareholders. Such a possibility could arise, for instance, if a firm liquidates for economic (or strategic) reasons as opposed to financial reasons. If we have such cases in our sample, then they are likely to weaken the

[3] There are obviously direct costs associated with bankruptcy filing. However, most recent studies suggest that, on average, these costs are relatively small (see Gilson, 1997; LoPucki & Doherty, 2004; Lubben, 2000; Maksimovic & Phillips, 1998), particularly in light of the documented improvement in operating and market performance following the filing (see Barniv et al., 2002; Kalay et al., 2007).