

Pricing the strategic value of putable securities in liquidity crises[☆]

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Abstract

Putable security holders have a *de facto* first claim on the firm's liquid assets and can threaten to force solvent issuers to bear financial distress costs. Their threatening power implies that the puts have a *strategic* value larger than their *intrinsic* value. Strategic value depends on the issuer's size, potential distress costs, and the distribution of put ownership relative to the firm's liquidity position. The analysis of Kmart's put-induced crisis in 1995, and a calibration to observed secondary market yield reductions on poison put bonds, shows that strategic value is an important determinant of payouts received by bond-holders. © 2001 Elsevier Science S.A. All rights reserved.

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1. Introduction

Putable securities have been issued under various forms by corporations in recent years, often motivated by the need to protect investors against major declines in value, and thus they potentially thicken markets by drawing in more conservative classes of investors. However, as revealed in several cases in the financial media in recent years, such securities can often exacerbate liquidity crises for solvent issuers because they provide security holders a de facto first claim on the firm's available funds following a major credit-debilitating event, giving them the ability to force the issuer to either incur costly asset sales, raise its borrowing costs, or, in the most acute cases, file for a costly bankruptcy. Holding a threatening weapon can induce gaming behavior among such security holders and often these bondholders can use their strategic position to extract payments from equity holders in excess of the contracted payment at the time of exercise. Along similar lines, Dunn and Spatt (1999) suggest that the ability of putholders to extract a side payment from the mortgage borrower at the time of a costly refinancing partly explains why such lending contracts are typically callable but not putable. In this paper, I model multilateral negotiations between putable bondholders and the firm in an explicit financial distress setting and show that the strategic value of a typical bondholder depends on his size, on the issuer's potential financial distress costs, and on the distribution of ownership of putable debt relative to the firm's liquidity position. The analysis of Kmart's put-induced crisis in 1995, and a calibration to observed secondary market yield reductions on poison put bonds, shows that the strategic value is an important determinant of payouts received by putable bondholders.

Two highly publicized negotiations illustrate the severity of the possibilities discussed. In September 1995, Kmart Corp. was on the brink of a bankruptcy filing because of the downgrading of its debt to nearly speculative grade by the major rating agencies. A further downgrade would trigger the put of \$550 million of poison put bonds. Despite having more than \$1 billion in cash and other marketable securities, and an overall asset value of \$16 billion, Kmart was prohibited by covenants written by senior bank lenders to accelerate payments on more than one-fifth of the outstanding putable debt. The covenant limited the extent of the effective violation of seniority through put exercise on junior debt, thus preserving the value of senior holders amid declines in firm value. Therefore, exercise of more than a critical proportion would force Kmart into

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