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Determinants of financial distress and bankruptcy in highly levered transactions

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ABSTRACT

Prior literature on highly levered transactions (levered buyouts or levered recapitalizations) has emphasized either changes in governance or the structuring of their financing in helping these firms avoid financial distress or bankruptcy. Observing a sample of HLTs over time, we observe that debt composition is a more critical influence than proposed changes in governance for the likelihood of an HLT avoiding financial distress or bankruptcy. Such evidence is consistent with the [Chemmanur, T. & Fulghieri, P. (1994). Reputation, renegotiation, and the choice between bank loans and publicly traded debt. *Review of Financial Studies* 7, 475–506] model and suggests that the critical factor is the ability to informally renegotiate debt terms with a few lenders.

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1. Overview

Why do some firms that engage in a highly levered transaction, like a levered buyout or levered recapitalization, encounter financial distress or go bankrupt? More specifically, what is the relative role of changes in their governance and their financing in these outcomes? Some have argued that private equity firms play a special role in helping their portfolio firms avoid such outcomes. However, this conjecture begs the question of how do private equity firms do this; is it by changing firm governance, by structuring the financing of the target to facilitate re-negotiation or both? Thus, the core issue

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is whether highly levered transactions avoid financial distress or bankruptcy because of governance changes and/or because of the way they are financed?

To address this issue, we examine a sample of HLTs from 1985 through 1990. To present the hypotheses that we test and our evidence on them, we organize our paper as follows. In Section 2, we provide a brief review of the relevant literature and present our hypotheses. In Section 3, we describe our samples and sample data. In Section 4, we provide an analysis of control changes in HLTs, debt composition of HLTs, and the factors influencing the incidence of financial distress and bankruptcy in HLTs. In Section 5, we summarize our evidence and report our conclusions.

We find that after accounting for their debt load and its composition, changes in governance are not significant influences on the incidence of either financial distress or bankruptcy in HLTs. Consequently our evidence suggests that if a private equity firm plays a special role in helping LBOs avoid bankruptcy then it is more likely through their structuring of the firm's debt rather than through their restructuring of the firm's governance. Our evidence is consistent with Chemmanur and Fulghieri (1994) who propose that banks appear to reduce 'inefficient' liquidation, which suggests that reputation effects are important to banks.

2. Selective review of prior literature and the identification of hypotheses

Following a leveraged buyout or recapitalization, firms are changed either because they are managed differently or because they are financed differently. In accounting for the success of some of these transactions, some researchers emphasize changes in their governance (e.g., Jensen, 1989), while other researchers emphasize the discipline imposed by debt (e.g., Zwiebel, 1996).

Similar issues arise when considering why some buyouts encounter financial distress or bankruptcy and others do not. For example Opler (1993) suggests that private equity firm involvement in a leveraged buyout reduced its odds of encountering financial distress or going bankrupt. Opler presents evidence that the cost of debt for an LBO when organized by an LBO specialist is lower than for an LBO that is not organized by an LBO specialist. He argues that this is because an LBO specialist reduces the anticipated probability of the LBO firm encountering financial distress or bankruptcy. However, whether the reduced cost of debt for an LBO organized by an LBO specialist is due to their effect on its governance and/or by the structuring of its financing was not addressed.

Cotter and Peck (2001) argue that private equity specialists who organize a levered buyout (LBO) significantly reduce the likelihood that the firm will encounter financial distress or go bankrupt through their efforts to change incentives and governance in the post-LBO firm. However, Zwiebel (1996) demonstrates that their conjectured gains could arise from the effect of the firm's increased debt load. This point is reinforced by the lack of performance differences between levered buyouts and recapitalization observed in Rosenthal (1992), or the lack of performance differences in reverse LBOs between firms with and without LBO specialist involvement reported in Liu, Chou, and Gombola (2004).¹ Consequently, whether private equity firms play a special role in avoiding financial distress or bankruptcy, and more importantly, what role do they play, are still open questions.

In contrast, Kaplan and Stein (1993) provide evidence that LBO debt composition plays a critical role in determining the likelihood that an LBO goes bankrupt. Specifically, they find that LBOs that use more private debt than public debt are less likely to go bankrupt. Such evidence is consistent with the models of Chemmanur and Fulghieri (1994), Gertner and Scharfstein (1991), Bolton and Scharfstein (1996) and Welch and Bris (2001). These models suggest that debt composition and the number of debt holders (debt concentration) should have a significant effect on the costs of renegotiating debt, and hence on the incidence of financial distress or bankruptcy. These conjectures are consistent with the Trust Indenture Act of 1939 requirement that firms must receive the unanimous consent of bondholders to alter any of the material terms in the bond indenture. Clearly, such a requirement can create holdout problems.

¹ Further Cotter and Peck based their conclusion on the significance of regression coefficients in regressions that are insignificant. Such evidence signals a severe form of multicollinearity as discussed in Maddala (1977).

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