

Financial Distress and Bank Restructuring of Small to Medium Size UK Companies

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Different approaches to corporate bankruptcy. The US: 'soft' law. The UK: 'hard' law



- Mr. Miller (CEO, Bethlehem Steel):
"Chapter 11 does not solve our problems. It provides us [with] a process and a framework within which we can address and explore the significant issues facing the company."
• BBC, (Oct 16 2001)



William Hogarth (1697-1764)
'Arrested for debt'

The basic difference: the role of the court

The UK

- formalistic judges
- strictly enforce the creditors' rights
- in a *contract-driven system*

- The US
- activist (discretionary) judges
- particularly: review the liquidation decision of the secured creditors
- Chapter 11
 - violate absolute priority
 - for the sake of the 'common good'

The US approach is winning market share

- Among academics
 - there is almost a consensus that Chapter 11 works well
- Among policy makers
 - all recent policy reforms were in the direction of Chapter 11
- The argument: judges need to
 - resolve the co-ordination failures among the dispersed lenders
 - creditors' runs
 - prevent the secured creditors from abusing their power
 - premature liquidations
 - 'lazy banking'

Theory: dispersed lending

Berglof VonThadden (1994), Bolton Scharfstein (1996)

Fundamentals: debt 100, liquidation value 50

debtor has all the bargaining power

what happens when the debtor tries to renegotiate the debt?

Single creditor

the creditor will accept an offer
down to 50

Two lenders

*Each with a liquidation right over
the whole firm*

the creditors will reject the offer
and ‘run on the firm’

Conclusion

dispersion of liquidation rights might

‘harden the budget constraint’

prevent debt renegotiations

- it may also make the firm vulnerable to creditors’ run

The data

A comprehensive view: the distress cycle

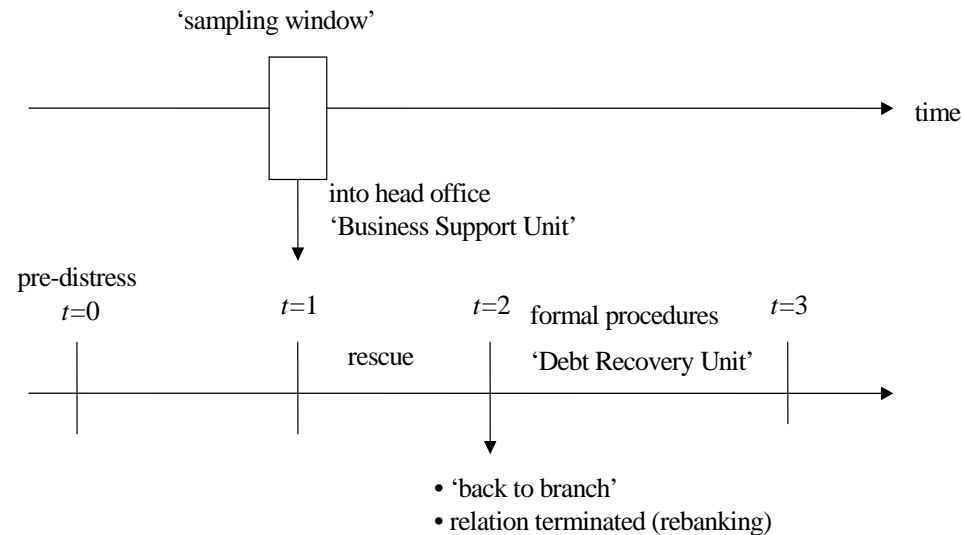
- Distress is defined by entry to the
 - business support unit (BSU)
- three clearing banks
- sampling window: 1997-1998
 - 532 companies

Distress ends in

- liquidation: debt recovery unit (DRU)
- rehabilitation: back to branch

Other features

- dynamic
- small companies, privately held
- private record



Any evidence for the dispersion of liquidation rights? NO!

The 'floating charge'

- a mortgage attached to the whole pool of company's assets
 - including rolling stock
 - cash flows
 - present and future
- effectively, provides the holder default-contingent control rights
- Even more powerful when given against an overdraft facility
 - the bank may call back the debt
 - if the firm fails to repay within 48-hours
 - it is in default

Dispersion of liquidation rights (cont.)

Sources of funding (Table 2)

• main bank	38%	49%	42%
• trade credit	24%	37%	40%
• fixed or floating charge	100%	98%	95%
• personal guarantees	60%	51	55%
• security/bank loan	104%	75%	119%

Dispersion of liquidation rights (cont.)

Recovery rates (on $t=2$ debt)

- | | | | |
|----------------------------|-----|------|------|
| • banks (mean) | 74% | 77% | 76% |
| • banks (median) | 88% | 100% | 100% |
| • prefs (med) | | 3% | |
| • trade creditors (median) | | 0 | |

Any evidence that banks are 'soft' in renegotiations?
NO!

Write-downs

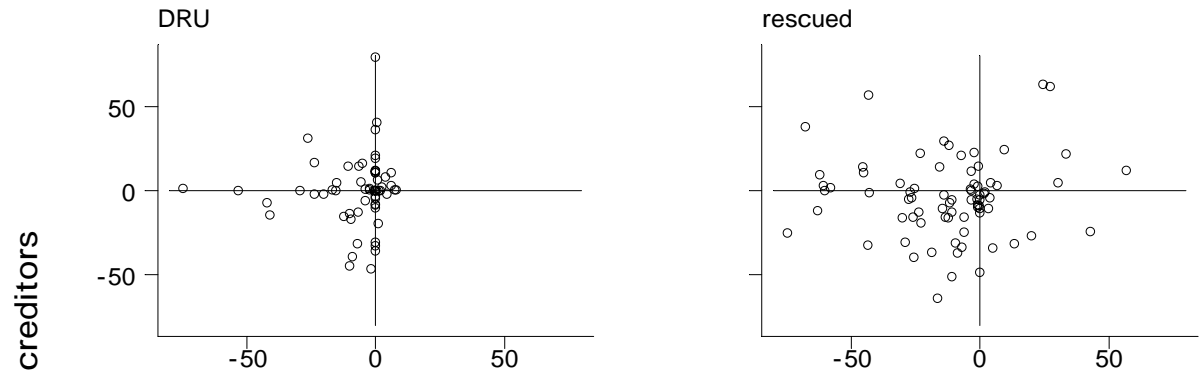
- only one case is reported in all our sample
- modification: spreads are flat during the rescue process

Maybe the write-downs are implicit

- such as expanding credit during distress?

Soft banks (cont.)

- “[a supplier] may have lent his money or consigned his goods to the company last week, but if he has the audacity to ask for payment ... the debenture holders obtain a receiver ... taking his money or his goods.”
- (Justice Buckley, *Re London Pressed-Hinge Co.*, 1905)



credit flows to distressed firms
the bank and the trade creditors
sorted by outcome
Bank 2

by bank
Graphs by resolution in BSU

Any evidence for a creditors' run?

NO!

A theoretical point: once the liquidation rights are concentrated, theory predicts no creditors' runs

- 11 winding-up order in the whole sample
- Bank 3: 109 cases of distress
 - 100 initiated by the bank
- Prob(DRU) regression
- trade credit shrinks =>
 - *lowers* the likelihood of DRU z-stat 1.8 to 2

Creditors' run is not a generic problem of distress

- ***but rather an implication of a particular capital structure***
- ***the problem has a contractual solution***
 - ***which the markets implement quite successfully***

Any evidence that concentrated lending causes lazy banking?

MAYBE

- the bank “may decide against keeping a good company going because it does not see the upside potential. Moreover, even when the bank does decide to sell a company as a going concern, it may not have an incentive to push for a high sale price, given the ceiling on its returns. As a result, there may be little left over for junior claimants”
- Hart (1995)

Any evidence that concentrated lending causes lazy banking?

MAYBE

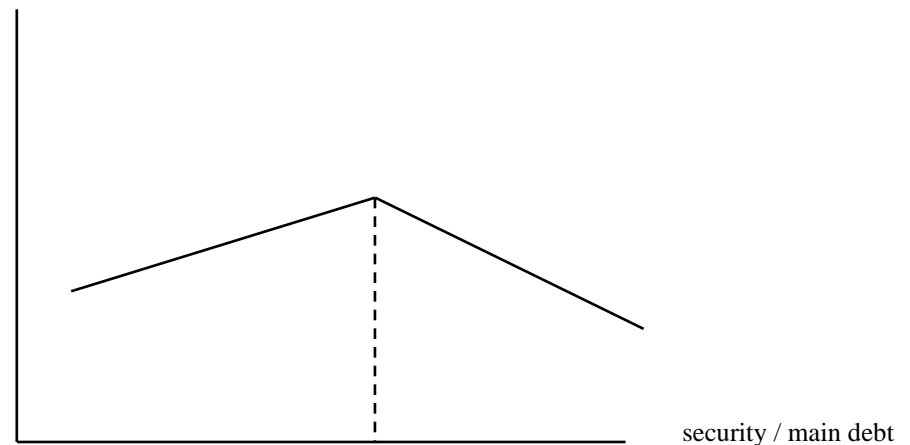
Evidence against lazy banking

- There is an elaborate rescue process
- Managerial replacement =>
 - *lowers* the likelihood of formal insolvency (z-stat. -3.2 to -3.5)
 - interesting: firms that replace managers are bigger

Evidence in favour of lazy banking

- Bank credit tends to shrink
- Security value and liquidation
 - (z-stat 0.7 and -1.13)
- Direct cost (% of liquidation value)
 - 42
 - 24
 - 39

prob(DRU)



Additional findings

- 1 case where the appointment of a receiver was challenged in court
 - dismissed in after a short hearing
- the going-concern rate
 - roughly 50%
 - the English system provides a speedy mechanism for
 - putting the assets, patents, networks
 - under a new ownership
 - with a debt relief

Conclusion

- The basic dilemma
 - enforcing the debt contract (UK)
 - putting it under judicial review (US)
- The jury is still out on which approach is better
- Emulate of the US system: not necessarily the best policy
 - in emerging markets
 - transition economies
 - in sovereign debt