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Corporate Financial Distress and Bankruptcy: A Survey

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Abstract

This survey provides a synthetic and evaluative survey of issues in corporate financial distress and bankruptcy. This area has moved into a public domain as a result of the recent global financial crisis that witnessed failures of many venerable institutions that got rescued by the government. Hence, this survey highlights the resolution mechanisms not only in the private domain but also in the public domain, and it uses corporate finance paradigms to interpret some of the far-reaching developments in financial distress of systemic nature. This survey's theoretical anchor is a framework for the delineation of economic distress and financial distress. The difficulty in disentangling the dichotomy has been a central challenge in the empirics relating to financial distress, corporate bankruptcy, and the use of apparently cost-effective private mechanisms for resolving financial distress. This review devotes ample space on the discussion of conditions under which privatization of bankruptcy succeeds and fails, and the recent empirics on the subject.

The review also grapples with the efficiency of bankruptcy codes and regimes, given the frequent usage of court-supervised mechanisms. The fundamental efficiency question about the bankruptcy law is whether the law effectively rehabilitates economically efficient but financially distressed firms and liquidates economically inefficient firms. This survey provides an ongoing debate in law and in economic theories about the efficiency of the U.S. bankruptcy code. Moreover, it examines a linkage between financial distress and corporate governance, which has received growing attention. The review goes beyond the United States to take a look at comparative bankruptcy codes around the world with a focus on bankruptcy reform issues in emerging economies. Finally, this survey takes us into a public domain and systemic financial distress. This is inspired by the recent global financial crisis. Is the standard bankruptcy procedure (e.g., those embedded in Chapters 11 and 7) sufficient for resolving systemic financial distress? The review attempts to answer this question in the context of the recently adopted landmark legislation, particularly the Dodd-Frank Act's Title II (Receivership), which governs the resolution of systemically critical institutions.

Contents

1

Introduction

There have been important developments in the area of corporate financial distress and bankruptcy since the comprehensive survey by Senbet and Seward (1995). This current survey builds upon the previous survey and repositions the debate in the context of the new developments.[1] The review provides a synthesis starting with the theoretical foundation and moving onto the empirical results. Surprisingly, many issues surrounding corporate financial distress and bankruptcy are still unresolved, and ample opportunities still exist for further research. We hope that the review will stimulate such research beyond setting the state-of-the-art in the area.

This area has moved into a public domain as a result of the recent global financial crisis that witnessed failures of many venerable

[1] There is another recent survey that focuses on the empirics of distress resolution mechanisms (Hotchkiss et al., 2008). That survey mainly reviews the empirical research on the use of private and court-supervised mechanisms for resolving financial distress. Our survey has a comprehensive coverage of both theory and empirics in this area. The timing of our survey also allows us to discuss the issue of systemic financial distress triggered by the global financial crisis and economic recession in recent years, and discuss the resolution mechanisms not only in the private domain but also in the public domain. In the empirical part, the two surveys have some overlap, yet have different emphasis on the topics covered.

institutions that got rescued by the government. The determination on the part of the government to prevent a repeat of such bailouts has led to the landmark legislation in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter Dodd-Frank Act). In particular, the Act provides for a resolution authority akin to private workouts but under government authority. The panic surrounding the global crisis and government intervention led to a departure of a normal workout and restructuring in which creditors were made whole while equity was wiped out. The Dodd-Frank Act purports to overcome the tax-payer bailouts and facilitate orderly distress resolution. Thus, this survey will highlight the resolution mechanisms not only in the private domain but also in the public domain, and we will use corporate finance paradigms to interpret some of these far-reaching developments in financial distress of systemic nature.

The outline of the survey is as follows. Section 2 provides the institutional features of financial distress and bankruptcy, focusing on the workings of the U.S. bankruptcy system as characterized by the features of Chapter 11 (reorganization) and Chapter 7 (liquidation). Section 3 provides a review of the major theoretical developments in corporate financial distress and bankruptcy, beginning with the Modigliani–Miller analog of bankruptcy irrelevancy to firm valuation and then moving onto the imperfect world with a focus on the efficiency characteristics of the private/market-based mechanisms and court-supervised mechanisms of resolving financial distress.

Section 4 reviews the available empirical work on financial distress and bankruptcy in a synthetic fashion. The synthesis for the overall interpretations of the many empirical studies is guided by our discussion of the theoretical predictions in Section 3. The review here begins with the fundamental question about the extent to which financial distress and bankruptcy costs are significant, and the extent to which these costs are internalized and externalized. The section highlights important changes that have taken place over the last two decades in both private workouts and court-supervised resolution mechanisms. It also includes discussions about the empirical evidence for post-bankruptcy firm performance and governance issues associated with financial distress.

Section 5 looks at comparative bankruptcy codes around the world, which tend to vary along creditor rights and financial distress resolution mechanisms. In particular, we highlight bankruptcy features in several European countries differentiated by legal origin — the United Kingdom, France, Germany, and Sweden — and recent bankruptcy reforms in two BRIC countries — Brazil and India.

Section 6 examines the systemic nature of financial distress and bankruptcy. This is inspired by the recent events in the global financial crisis and the introduction of the landmark legislation — the Dodd-Frank Act. In particular, the review deals with the extent to which resolution mechanisms in the private domain can be applied to systemic crisis resolution, and the similarities and contrasts between the Dodd-Frank resolution regime and the existing corporate bankruptcy regime.

Since this survey is fairly long, we provide a summary of all the discussions in Section 7 so that readers can get a concise overview of the essential topics covered in this survey. We also point out fruitful areas for future research on corporate financial distress and bankruptcy.

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