Financial Distress

A firm is considered in financial distress when its cash flow is not sufficient to cover current obligations. Firms need not be declared bankrupt at the moment this situation occurs. In Kenya, creditors can only ask the court to invoke the "bankruptcy" procedure when the firm cannot pay debts due. If the firm has some cash reserves left, or sells off some assets, it may yet be able to evade bankruptcy.

The concept of "insolvency" is also used by economists to characterize firms in financial distress. Insolvency can be defined as the situation where the firm has a negative economic net worth. It may, however, still be able to pay current obligations. Once a firm is in financial distress the issue becomes how this distress situation should be resolved. To resolve the financial problems the firm can restructure the assets or the liabilities and both can be done informally, i.e. without invoking the bankruptcy procedure, or by means of a formal bankruptcy. Table 1 gives the methods associated with each of these types of restructuring.

Table 1: Methods to resolve financial distress.

	Asset restructuring	***Financial restructuring***
Informal restructuring	*Merger/ sell off assets*	*Informal workout*
Formal restructuring	*Liquidation in bankruptcy*	*Formal reorganization in bankruptcy*

A firm restructures its assets to free up cash flow. This can take the form of a sale of assets, a reduction in the labor force, a reduction in capital spending, research, and development.
Asquith et al. (1994) find that asset sales and capital expenditure reductions play an important role in the restructuring of companies. After these asset sales, these firms have a lower chance of going bankrupt, compared to firms that do not sell assets. The findings of Asquith et al. (1994) point to the fact that most companies use the proceeds from the asset sales to pay off (senior) debt. However, it need not be the stockholders that gain the most from these asset sales. The asset base of the firm diminishes and this eliminates equity's option on any future increase in asset values. For this reason, financially distressed firms reinvesting the proceeds of asset sales in their firm show higher average abnormal returns than those firms paying down debt (Brown et al, 1994).

Although empirical studies shed light on what happens to firms that restructure their assets informally, relatively little is known about firms that liquidate under the bankruptcy code. One prominent difference with informal asset restructuring is that in bankruptcy the liquidation of the firm is not carried out by management, but by an outsider appointed by the court. The associated loss of control makes the asset sale under bankruptcy law far less attractive to management and shareholders.

The other option for the firm to resolve financial distress is to restructure the liabilities, informally or formally. Gilson et al. (1990) find that the average length of time is shorter and that direct costs are lower for informal reorganizations than for formal procedures. They also find that in informal workouts stockholders gain on average 41 percent in stock value, while the firms that failed in their attempt and ended in bankruptcy showed a –40 percent abnormal return *over the restructuring period. Part of this difference may be attributable to differences in operating performance, but it also reflects the cost savings associated with an informal reorganization. Although these cost savings raise a firm's value relative to its value in bankruptcy, the firm participants must agree unanimously how to distribute this value. Holdout problems and free riding by atomistic debt holders, information asymmetries between management and creditors, and conflicting coalitions may lead to the breakdown of the informal reorganization. Gilson et al. (1990) find that firms with more intangible assets, more bank debt relative to public debt and fewer (distinct classes of) lenders have a higher chance of successfully completing an informal workout.*

The alternative to the informal workout is the formal reorganization under the bankruptcy law. Important issues addressed are the costs associated with the procedure and the violation of the absolute priority rule (APR). The costs of financial distress are categorized as direct and indirect costs. The direct costs are the sums paid to the lawyers and advisors to the firms. The indirect costs are the costs associated with the disruption of the normal business activities due to the financial problems. Warner (1977), Altman (1984), and Weiss (1990) show that the direct costs range between 3 and 5 percent of the market value of the firm, measured at the yearend prior to bankruptcy. Incorporating the indirect costs into these estimates is problematic. Altman (1984) estimates total bankruptcy costs, i.e. direct and indirect costs, as 8 to 12 percent of total firm value for retailers and 16 percent for industrial firms. Haugen and Senbet (1978) argue that these costs can be evaded by buying up all financial claims of the firm on the capital market, thus capping the total costs of bankruptcy. However, it was only after the leveraged buyout (LBO) period of the 1980s that the active market in distressed securities that makes this kind of informal restructuring possible developed.

The second issue, the violation of the APR, addresses the redistribution of wealth in bankruptcy. Weiss (1990), Franks and Torous (1989, 1994), and Eberhart et al. (1990) show that not only in Chapter 11, but also in informal workouts, the APR is violated. This rule asserts that junior claimants (including equity) may only receive financial consideration when more senior creditors are paid in full. The idea behind this rule is that the seniority of claims, as written in financial contracts, should be honored in bankruptcy. If these contract terms are not held up in bankruptcy, then junior claimants have the incentive to use the bankruptcy procedure to expropriate wealth from senior creditors. The reason for this expropriation lies in the formal procedure that gives junior claimants bargaining power over senior creditors. However, all parties know before they enter into a financial contract what to expect in bankruptcy, and credit terms are set accordingly. Altman (1993) argues that it should be these credit terms that should be honored. If the absolute priority doctrine is used, then some parties receive windfall profits. This debate over priority rules and the costs associated with the violation of such a rule has not yet been settled. Another unresolved issue concerns the efficiency of bankruptcy rules. For instance, it is not clear whether the bankruptcy code keeps too many firms alive that should have been liquidated. A promising area of research that could also shed light on the efficiency issue is the analysis of the bankruptcy systems of different countries. The analysis of the differences between these rules could facilitate the research for more efficient bankruptcy rules.

A related area of research is the design of (optimal) bankruptcy rules. This should also enhance our understanding of current rules and the reason why these rules may lead to inefficiencies in *economic decisions. Finally, the behavior of the claimants in financial distress situations, and especially the role of banks or informed outsiders, deserves further attention.*

Costs of financial distress

We specifically focus on the costs and benefits of financial distress, with specific emphasis on bankruptcy.

Is bankruptcy always bad?

You rarely hear anything nice said about corporate bankruptcy. But there is some good in almost everything. Corporate bankruptcies occur when stockholders exercise their right to default. That right is valuable; when a firm gets into trouble, limited liability allows stockholders simply to walk away from it, leaving all its troubles to its creditors. The former creditors become the new stockholders, and the old stockholders are left with nothing. In fact, managers may declare bankruptcy as a strategic move to buy time (in bankruptcy, the firm is shielded from creditors) to reorganize itself. It is not always right to think of bankruptcy as corporate funerals.

Direct versus Indirect Costs of Bankruptcy

We have mentioned the direct (that is, legal and administrative) costs of bankruptcy. There are indirect costs too, which are nearly impossible to measure. But we have circumstantial evidence indicating their importance. Some of the indirect costs arise from the reluctance to do business with a firm that may not be around for long. Customers worry about the continuity of supplies and the difficulty of obtaining replacement parts if the firm ceases production. Suppliers are disinclined to put effort into servicing the firm's account and demand cash on the nail for their goods. Potential employees are unwilling to sign on and the existing staff keeps slipping away from their desks for job interviews.

Managing a bankrupt firm is not easy. Consent of the bankruptcy court is required for many routine business decisions, such as the sale of assets or investment in new equipment. At best this involves time and effort; at worst the proposals are thwarted by the firm's creditors, who have little interest in the firm's long-term prosperity and would prefer the cash to be paid out to them. Sometimes the problem is reversed: The bankruptcy court is so anxious to maintain the firm as a going concern that it allows the firm to engage in negative-NPV activities.

Financial Distress without Bankruptcy

Not every firm that gets into trouble goes bankrupt. As long as the firm can scrape up enough cash to pay the interest on its debt, it may be able to postpone bankruptcy for many years. Eventually the firm may recover, pay off its debt, and escape bankruptcy altogether. When a firm is in trouble, both bondholders and stockholders want it to recover, but in other respects their interests may be in conflict. In times of financial distress the security holders are like many political parties—united on generalities but threatened by squabbling on any specific issue. Financial distress is costly when these conflicts of interest get in the way of proper operating, investment, and financing decisions. Stockholders are tempted to forsake the usual objective of maximizing the overall market value of the firm and to pursue narrower self-interest instead.