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Bankruptcy, boards, banks, and blockholders

Evidence on changes in corporate ownership and control when firms default

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In 111 publicly traded firms that either file for bankruptcy or privately restructure their debt between 1979 and 1985, bank lenders frequently become major stockholders or appoint new directors. On average, only 46% of incumbent directors remain when bankruptcy or debt restructuring ends. Directors who resign hold significantly fewer seats on other boards following their departure. Common-stock ownership becomes more concentrated with large blockholders and less with corporate insiders. Few firms are acquired. Collectively, these results suggest that corporate default leads to significant changes in the ownership of firms' residual claims and in the allocation of rights to manage corporate resources.

1. Introduction

Corporate financial theory has long recognized the potential impact of bankruptcy-related costs on firms' capital structure decision and managerial incentives [Masulis (1988), Jensen (1988)]. We know little, however, about

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how firms actually deal with default, and what changes take place in these firms as a consequence of financial distress. For example, there has been little empirical analysis of corporate governance in financially distressed firms. Although models of bankruptcy often assume that creditors take control of the bankrupt firm's assets, the actual role creditors play has not been systematically documented. Similarly, there is little evidence on how ownership of distressed companies' residual claims changes as debt is renegotiated. We also do not fully understand what determines the incentives of companies and their creditors to recontract out of default privately instead of through formal bankruptcy [Jensen (1989a, b)].

This study presents new evidence on these and related issues. The study is based on a sample of 111 publicly traded companies that experienced severe financial distress between 1979 and 1985. Sixty-one of these companies filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code, and fifty restructured their debt privately.

Collectively, the results of this study suggest that corporate default engenders significant changes in the ownership of firms' residual claims and in the allocation of rights to manage corporate resources. In approximately three out of four firms in the sample, bank lenders and other creditors receive significant blocks of voting stock under firms' debt-restructuring and Chapter 11 reorganization plans. On average, banks receive 36% of firms' common stock. In a number of cases, banks appoint their representatives to the board of directors. Restrictive covenants in privately restructured lending agreements give banks more say in firms' investment and financing policies.

Concurrently with the banks' increased monitoring, significant internal changes take place in the board of directors. On average, only 46% of directors who sit on the board prior to financial distress, and 43% of the CEOs, are still present when their firms emerge from bankruptcy or settle privately with creditors less than two years later. The average size of the board declines, and more directors are appointed who possess some special skill or interest in managing troubled companies, including investment bankers and workout specialists. Directors who resign from these firms subsequently serve less often as directors of other companies. At the same time, the percentage of firms' common stock held by large nonmanagement blockholders rises sharply. Very few firms in the sample are involved in any sort of acquisition-related activity.

Evidence presented here is consistent with a general substitution of monitoring by external blockholders and creditors for monitoring by directors. Interestingly, many of the monitoring mechanisms that increase in importance for these insolvent firms have been also identified with the LBO form of organization. As Jensen (1989b) observes, a typical LBO has highly concentrated stock ownership, bank lenders that are active in making and implementing corporate policy, and a board of directors that includes invest-

ment bankers and other professionals who specialize in running highly levered companies. Such evidence, coupled with results of the current study, suggests that leverage is a potentially important determinant of how corporations are best organized and governed.

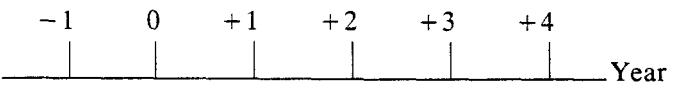
This paper is organized as follows. Section 2 discusses the data and sample design. Section 3 presents the empirical results, and section 4 concludes with a summary of the study's main findings.

2. Data and sample description

No systematic public records are kept of firms that default on their debt or file for bankruptcy. For this study, I created a sample of such firms indirectly from a list of publicly traded companies whose common stock price dropped steeply. I assumed that such a list would contain a relatively large number of firms that were financially distressed – that is, either in default on their debt, bankrupt, or restructuring their debt to avoid bankruptcy. For each year from 1979 to 1984, I ranked all firms on the New York Stock Exchange (NYSE) and American Stock Exchange (Amex) by their three-year unadjusted common stock returns, obtained from the Center for Research in Securities Prices (CRSP) daily-returns file, and formed a stratum of firms whose returns fell in the bottom 5%. I then searched the *Wall Street Journal (WSJ) Index* for references to each firm in the stratum, looking at a five-year period centered on the year(s) in which the firm was sampled. A firm was retained for analysis if there was some mention of a default, bankruptcy, or attempt to restructure debt outside of bankruptcy. Additional sources used to confirm the presence or absence of these events include the *Moody's* Manuals, the Q-file directory of firms' 10k reports and shareholder proxy statements, Standard and Poor's *Bond Owner's Guide*, and Commerce Clearing House's *Capital Changes Reporter*. This procedure produced an initial sample of 150 financially distressed firms.

An informal debt restructuring agreement yields the same result as a formal reorganization plan in bankruptcy, in that both represent an exchange of new financial claims for the firm's previously outstanding debt contracts. There are no established legal or economic criteria, however, for determining when a debt restructuring agreement has occurred. Following Gilson (1989), I define a debt restructuring as a transaction in which the firm's debt contracts are amended on one of the following terms: (i) promised interest or principal payments on the debt are reduced; (ii) the debt's maturity is extended; or (iii) creditors are given equity securities in the firm (common stock or securities convertible into common). All debt restructurings in the sample take place in response to an actual or anticipated default, or for the purpose of avoiding bankruptcy.

The following schematic illustrates the dating convention I use to evaluate changes in board membership, stockholdings, and other variables:



Time 0 represents the date on which a firm either files for bankruptcy or starts to restructure its debt privately. A debt restructuring is assumed to begin on the date it is first mentioned in the *WSJ*, unless an earlier date can be determined from other source documents. If a firm defaults, I assume that efforts to restructure its debt begin immediately, since creditors can generally demand immediate payment of all interest and principal after 30 days. A bankruptcy begins on the date that a firm files under Chapter 11 of the U.S. Bankruptcy Code.

Although firms can (and usually do) attempt to restructure their debt privately before filing for bankruptcy, Gilson et al. (1990) report that such attempts typically break down within one year. Failing to account for this period should not seriously bias the results of the present study, since turnover and blockholdings are reported on an annual basis. Moreover, using the firm's Chapter 11 filing identifies changes in corporate ownership and governance that are specifically attributable to the Chapter 11 process.

Board membership, stock ownership, and other variables are tracked from year −1 onward. At the end of each event year actual board membership and stock ownership are assumed to be the same as reported in the most current proxy statement or 10k report. Turnover of directors is measured by comparing board membership in adjacent years. For example, if a firm's financial distress begins in October 1982 and its proxy statements are filed every March, then turnover between event dates 0 and +1 reflects changes in board membership from March 1982 to March 1983. If no SEC filings are made in a particular year because a firm cancels its annual shareholders' meeting or obtains a filing exemption, turnover, if any, is assumed to take place on the date of the first subsequent filing that reflects the change.

For each firm, board membership and stock ownership are tracked until the firm's bankruptcy or debt restructuring is resolved. The resolution date for bankruptcy is the date on which the firm's reorganization plan is formally confirmed by the court. For debt restructurings, the resolution date is either the date on which a restructuring agreement is formally consummated, or the date of the last reference in the *WSJ* to a continuing restructuring.

This dating convention ensures that observed turnover of directors is confined to periods when firms are financially distressed. If all firms were tracked until year +4 instead, some of the turnover for firms that returned to financial health more quickly would be unrelated to either bankruptcy or

debt restructuring, and the impact of default on directors' tenure would be overstated. If it is impossible to ascertain when a firm's financial distress ended, the resolution date is assumed to be year +2. This convention reflects the sample mean and median time that firms spend either in bankruptcy or private restructuring their debt (see table 2).[1]

To accommodate missing proxy statements and 10k reports, I require that enough documentation be available to determine at least one year's change in either board membership or stock ownership during a firm's financial distress. Thirty-nine firms failed to satisfy this criterion, leaving a final sample of 111 firms. The sample includes a number of large firms whose financial troubles have been the subject of much analysis and discussion in the financial press. Examples are Baldwin-United, Charter, Itel, and Wickes (bankruptcies), and Allis-Chalmers, Dome Petroleum, International Harvester, and Massey Ferguson (debt restructurings).

Table 1 shows when firms file for bankruptcy or start to restructure their debt privately. Clusters of both groups of firms in 1982–1984, a period of economic recession, account for 71.6% of the sample. In addition, over one-half of the sample falls into five broad industry categories, reflecting the recession's relative impact on different sectors of the economy. As defined by firms' two-digit standard industrial classification (SIC) industry codes, 18.4% of all sample firms are in mining, oil and gas extraction (SIC codes 10–14), 9.6% in real estate and financial services (60–67), 8.9% in transportation and communications (40–49), 8.8% in machinery and equipment manufacturing (35–36), and 7.9% in miscellaneous retail trades (52–59).

Table 2 presents selected characteristics of firms in the sample. Sampled firms are generally smaller than those analyzed in related studies. The mean and median book values of assets are $557.9 and $74.8 million, respectively. In contrast, median firm size for the sample of NYSE-listed firms analyzed by Hermalin and Weisbach (1988) is $1.2 billion. Firms in the sample could be relatively smaller because they have been consistently unprofitable and because they may have divested a significant fraction of their assets in an attempt to remain solvent. In addition, smaller firms will be observed in disproportionately large numbers when the sampling is based on low stock returns because their returns are more volatile.

My sampled firms are highly leveraged, as measured by the ratio of total liabilities or long-term debt to total assets (all in book values), and have relatively more bank debt than publicly traded debt outstanding. These firms

[1]Even when a firm's financial distress is resolved in less than a year, it is necessary to track board membership for two years to be sure of capturing all turnover that is related to financial distress, since corporate filings are made at annual intervals. For example, suppose that a firm files for bankruptcy in June 1983 (year 0), leaves bankruptcy in April 1984, and files its proxy statement each February. Turnover that takes place in March 1984 will be first reflected in the proxy statement dated February 1985, thus falling in event year +2. As discussed later, infrequent reporting of board turnover in the *WSJ* makes it necessary to rely on proxy statements as the principal source for determining when these changes take place.

Table 1

Calendar time distribution of starting dates for financial distress. Sample consists of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985.[a]

Year	Number of firms	
	Bankruptcy	Debt restructuring
1979	1	3
1980	6	4
1981	8	4
1982	18	15
1983	11	15
1984	14	9
1985	3	0
Total	61	50

[a]The sample consists of firms that went bankrupt or restructured their debt to avoid bankruptcy in any given year, from among all firms on the CRSP daily returns tape whose cumulative three-year common stock return in any year during the 1979–1984 period fell in the lowest 5% of all returns for that year. Each firm's status is determined from the *Wall Street Journal*, the *Moody's* manuals, the Q-file directory of annual 10k reports and proxy statements, and Commerce Clearing House's *Capital Changes Reporter*. A debt restructuring is defined as an agreement between the firm and its creditors to either (i) reduce stated principal or interest payments on the debt, (ii) extend the debt's maturity, or (iii) grant creditors an equity interest in the firm (common stock or securities convertible into common stock). In addition, the purpose of the debt restructuring must be to avoid bankruptcy or default.

are also extremely unprofitable, in both absolute and relative terms. Firms' profitability is represented by two variables. The first is the annual common stock return, averaged over the three years that precede the firm's bankruptcy or debt restructuring. The second is a measure of unanticipated earnings, equal to the annual difference in earnings before interest and taxes, divided by the book value of assets at the beginning of the fiscal year. Hermalin and Weisbach (1988) use the same measure of accounting performance. This variable is also a three-year average, ending with the fiscal year that overlaps the start of a firm's bankruptcy or debt restructuring. Sample means and medians are significantly negative for both stock price and accounting measures of profitability. This is true whether performance is measured in unadjusted terms, in relation to the market (for stock returns), or against the average performance of firms in the same industry (at the two-digit SIC industry level). These performance measures are also economically significant. For example, average annual unadjusted stock returns are −34.3%; corresponding market and industry-adjusted returns are −59.0% and −52.3%, respectively.

Although the foregoing sample characteristics might reasonably be expected of financially distressed firms in general, the present sample is taken from a stratum of firms with extreme negative stock returns. A priori, it is not clear how this might bias the results of the study. For example, the sample

Table 2

Selected sample characteristics. Where applicable, variables are based on reported information that most closely predates the beginning of firms' bankruptcy or debt restructuring. Sample consists of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985.[a]

	Mean	Median	Max.	Min.
Book value of assets ($millions)	557.9	74.8	10,208.7	6.3
Annual sales ($millions)	985.1	160.3	13,618.3	0.0
Number of shareholders	9,145	3,809	206,854	450
Number of employees	4,603	1,400	76,018	4
Leverage ratios				
Total liabilities ÷ book value of assets	0.87	0.85	1.92	0.39
Long-term debt ÷ book value of assets	0.52	0.51	1.22	0.01
Publicly traded debt ÷ total liabilities	0.10	0.00	0.66	0.00
Bank debt ÷ total liabilities	0.29	0.23	0.88	0.00
Annual common-stock returns (3-year average)				
Unadjusted	−0.343[b]	−0.362[b]	0.560	−0.680
Net of market	−0.590[b]	−0.575[b]	0.005	−0.926
Net of industry	−0.523[b]	−0.544[b]	0.028	−0.883
Annual difference in earnings before interest and taxes ÷ book value of assets (3-year average)				
Unadjusted	−0.030[b]	−0.027[b]	0.183	−0.173
Net of industry	−0.041[b]	−0.039[b]	0.174	−0.169
Length of financial distress (months)				
Bankruptcy	21.9	19.0	43.0	10.0
Debt restructuring	17.9	15.0	44.0	1.0

[a]See footnote a of table 1 for a description of the sampling methodology. Income and balance-sheet data are obtained from the COMPUSTAT Annual Industrial and Research tape and the *Moody's* manuals. Stock return data are obtained from the CRSP daily returns tape. Bank debt includes debt owed to commercial banks and insurance companies. Average annual stock returns are based on returns for the three consecutive years that end with the year in which a firm files for bankruptcy or starts to restructure its debt. The market return is the corresponding CRSP equally-weighted market portfolio return, and the industry return is the return on the equally-weighted portfolio of all firms with the same two-digit SIC industry code. The average annual difference in earnings before interest and taxes is based on the three consecutive fiscal years that end with the fiscal year in which a firm files for bankruptcy or starts to restructure its debt. The book value of assets used to deflate the annual difference in earnings is the value at the beginning of the fiscal year. The industry benchmark for this variable is defined by analogy with industry common stock returns.

[b]Mean (median) is significantly different from zero at the 0.01 level using a one-tailed t-test (Wilcoxon rank-sum test).

will tend to exclude defaults by firms that suffered only minor declines in their stock price (cash flows), but which were highly levered by choice before defaulting. Jensen (1989a, b) argues that an important benefit of high leverage is that poorly managed firms default sooner, thus forcing corrective changes in corporate policy to be undertaken sooner and allowing more of the firm's going-concern value to be preserved.

3. Financial distress and the market for corporate control

My main objective is to investigate changes in corporate governance that take place when firms default on their debt. Recent work by Jensen (1989a, b) suggests that leverage may be an important determinant of how decision rights in the firm are allocated among the claimholders. Because the impact of leverage (or default) on the allocation of these rights is not well understood, much of the following analysis is deliberately descriptive. Evidence is organized around changes in the importance of monitoring by the firm's creditors, the board of directors, and outside blockholders.

3.1. Monitoring by creditors

In the standard textbook treatment of financial distress, default engenders a wholesale transfer of the firm's assets to creditors. Although this is an admitted simplification of the actual events that occur around default, evidence presented below suggests that creditors (in particular, bank lenders) exercise significant influence over resource allocation in financially distressed firms. This influence derives from two sources: (i) explicit stock ownership and representation on the board of directors and (ii) restrictions on corporate financing and investment policy contained in the firm's debt covenants.

3.1.1. Creditor control through stock ownership and board representation

Table 3 documents the percentage of firms' common stock that creditors receive under debt restructuring and Chapter 11 reorganization plans. In panel A, ownership is defined as the largest percentage of common stock held by creditors in a particular class during firms' financial distress, as reported in annual proxy statements under 'beneficial ownership'. In panel B, ownership is defined as pro forma common stockholdings by creditors under the terms of firms' debt restructuring or reorganization plans. Sources used to determine pro forma stockholdings include 10k reports, exchange offer circulars, the *Moody's* manuals, and the *WSJ*. Ownership percentages reported in both panels are calculated under the assumption that any convertible securities held by creditors are fully converted into common stock. Ownership is presented for as many classes of creditors as the data allow. For example, stockholdings by individual bondholders in the sample are too small to be reported in proxy statements (panel A), although bondholders as a class often receive large amounts of stock (panel B). Similarly, inconsistent reporting of restructuring and reorganization plan terms across firms necessitates presenting pro forma ownership data on a more aggregated level than data obtained from proxy statements.

Proxy statements that disclose creditor blockholdings are found for 36.0% of firms that restructure their debt privately and 19.1% of firms that file for

Table 3

Percentage ownership of common stock by creditors in financially distressed firms. Figures are based on a sample of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 (61 firms) or privately restructured their debt to avoid bankruptcy (50 firms) between 1979 and 1985. In panel A, ownership is defined as the largest percentage of common stock held by creditors in a particular class while a firm is financially distressed (as reported in annual proxy statements). In panel B, ownership is defined as pro forma percentage stockholdings by creditors under the terms of a firm's debt restructuring or bankruptcy reorganization plan. Ownership percentages are calculated under the assumption that any convertible securities held or received by creditors are fully converted into common stock.[a]

Subsample/creditor class	Percentage ownership of common stock				Percentage of firms in sub-sample
	Mean	Median	Min.	Max.	
Panel A: Ownership reported in annual proxy statements					
Debt restructuring					
Banks	36.1	33.3	7.8	70.4	30.0
Insurance companies	26.3	23.4	0.0	32.3	6.0
Other corporate lenders	26.7	26.7	8.2	45.1	4.0
ESOPs	7.9	7.9	7.9	7.9	2.0
All creditors	*36.1*	*35.2*	*7.8*	*70.4*	*36.0*
Bankruptcy					
Banks	14.5	9.6	6.1	46.1	14.3
Insurance companies	9.3	7.8	5.4	14.7	4.8
Other corporate lenders	17.4	17.4	5.2	29.5	3.2
ESOPs	29.4	29.4	8.8	50.0	3.2
All creditors	*21.0*	*17.8*	*5.2*	*50.0*	*19.1*
Panel B: Pro forma ownership under terms of debt restructuring or bankruptcy reorganization plan					
Debt restructuring					
Banks and insurance companies	36.6	37.2	2.9	77.6	47.1
Public bondholders	33.0	26.8	3.6	86.1	43.1
All creditors	*41.9*	*45.8*	*4.9*	*86.1*	*70.6*
Bankruptcy					
All creditors	*79.2*	*88.0*	*45.0*	*97.4*	*75.0*

[a]Sources used to determine pro forma ownership include the *Moody's* manuals, the *Wall Street Journal*, firms' 10k reports, and exchange offer circulars. Ownership by public bondholders reflects the number of shares distributed under exchange offers net of any convertible securities surrendered by bondholders (assuming full conversion into common stock). For the subsample of bankrupt firms in panel B, ownership by all creditors equals 1.0 minus the fraction of common stock distributed to prepetition common stockholders under a firm's Chapter 11 bankruptcy reorganization plan, and percentage of firms in subsample equals the percentage of bankrupt firms that continued to operate as independent going concerns following confirmation of their Chapter 11 reorganization plans (relative to all firms whose ultimate fate following Chapter 11 could be verified from the aforementioned sources).

bankruptcy (panel A). These figures understate the actual frequency of creditor blockholdings, because many financially distressed firms do not file annual proxy statements, and because bank lenders are under legal and regulatory pressure to divest stockholdings in nonbank firms (see below). In panel A, creditors are allocated to four classes: banks, insurance companies, other corporate lenders, and employee stock ownership plans (ESOPs). Stock placements with ESOPs in the sample are all financed by wage concessions and are treated as restructuring of short-term debt. In firms that restructure their debt privately, mean stock ownership by all creditors is 36.1%, with a median of 35.2%; corresponding mean and median ownership percentages in bankrupt firms are 21.0% and 17.8%. Most of this ownership can be attributed to banks, which are represented in the large majority of firms with creditor stockholdings. Weighted by the relative frequency of their holdings, banks also hold significantly larger blocks than other classes of creditors. The maximum percentage ownership by banks in the sample is 70.4%.

Evidence in panel B confirms the importance of bank stockholdings in financially distressed firms. Banks and insurance companies receive stock under 47.1% of all debt restructuring plans in the sample. Under the terms of these plans, mean pro forma percentage ownership of these lenders equals 36.6%, with a median of 37.2%. The maximum percentage of common stock they receive is 77.6%. These figures are similar to those reported for banks in panel A. Collective stock ownership of public bondholders in the sample is also substantial. Restructuring of publicly traded bonds takes place through exchange offers. On average, bondholders receive 33.0% of firms' common stock under these offers, and at the median, 26.8%. In one case, bondholders receive equity securities equivalent to 86.1% of the firm's common stock.

Finally, panel B reports the percentage of stock creditors receive under Chapter 11 reorganization plans. Of all bankruptcies in the sample for which the final outcome of Chapter 11 could be determined, 75% result in creditors holding equity in the surviving firm; the remaining firms are either liquidated (6.3%) or merged into other firms (18.7%). Collectively, creditors receive 79.2% of bankrupt firms' equity on average, and 88.0% at the median. In contrast, collective stock ownership by creditors in firms that restructure their debt privately have a sample mean and median of 41.9% and 45.8%, respectively. The reasons for these differences are not investigated here, but they could bear on the choice between alternative recontracting mechanisms [Jensen (1989a, b), Gilson et al. (1990)].

The level of bank ownership documented in table 3 is influenced by a number of institutional and legal factors that prevent banks from holding large amounts of stock in nonbank firms. Such stockholdings are prohibited under Section 16 of the Glass-Steagall Act, the Bank Holding Company Act, and the Federal Reserve Board's Regulation Y. Although exceptions apply when banks obtain stock under a debt restructuring or bankruptcy reorgani-

zation plan, this stock must be divested within approximately two years. These constraints imply that blockholdings by banks, while often significant, may be shorter-lived than blocks held by nonbank entities. In addition, when banks receive equity securities under a debt restructuring plan they are more likely to be viewed as corporate insiders under bankruptcy law. As such, the banks can be forced to return any consideration received under the plan as a 'voidable preference' if the firm files for bankruptcy within one year. Banks are therefore more willing to accept stock in financially distressed firms when recontracting takes place in Chapter 11.

Banks' equity ownership allows them, as shareholders, to affect the outcome of board elections. I also find evidence that banks sometimes influence board membership directly. Three firms in the sample give banks a special class of equity security that guarantees them control over a minimum number of board seats. In three other cases, bank executives join the board while the firm is attempting to restructure its debt; in one such case a former bank officer becomes the firm's chairman and CEO. In two firms that restructure their debt privately, the entire board is replaced under bank pressure. For four bankrupt firms, a minimum fraction of board seats in the reorganized firm is reserved for members of the court-appointed creditors' committee. For all twelve cases, the mean percentage of board seats controlled by banks is 38.2%, with a median of 31.7%. These results support Masulis' (1988) conjecture that corporate insolvency often leads to direct lender representation on the board of directors.

Since a nontrivial fraction of board seats in these companies continues to be held by directors elected by nonbank stockholders, it is not clear how much influence banks actually have over board decisions, particularly when the interests of banks and stockholders differ. Some insight into the constraints that banks face in their role as directors is provided by a bank chairman who was appointed to the board of Massey Ferguson during its debt restructuring (included in the current sample), who remarked: 'I will certainly have the bank's interest in mind, but I also hope to represent Massey's shareholders' (*WSJ*, 13 October 1980, p. 24). A plausible motive for having made this statement is that the bank wished to reduce its legal liability to Massey's stockholders. Under lender liability laws, banks (and other creditors) can be sued if they take actions that undermine the value of the firm's other claims [Douglas-Hamilton (1975), Smith and Warner (1979)].

3.1.2. Bank control through restrictive covenants

Additional evidence on the monitoring role of banks is presented in table 4, which provides a breakdown of the restrictive covenants included in 40 privately restructured bank lending agreements in the sample. Data on covenants were collected from firms' 10k filings, the *Moody's* manuals, and

WSJ reports of restructurings. Examination of these covenants provides some insights into the nature of the power exercised by banks in financially distressed firms.

In general, the covenants documented in table 4 grant banks property rights in the firm's assets directly. Ordinary loan agreements, in contrast, tend to contain only indirect restrictions on investment policy, through the operation of covenants that restrict the firm's dividend and financing policies [Smith and Warner (1979)]. Particularly striking is the number of cases in which banks are granted an explicit veto over the firm's investment and financing policies.[2] For example, banks have veto power over changes in senior management, the firm's annual operating budget, capital expenditures, mergers, divestitures, sales of new debt or equity, and the payment of dividends.

Also relatively common are agreements that grant banks increased collateral, or restrict the firm's ability to grant collateral without first obtaining banks' consent; approximately 75% of the restructured bank loan agreements contain such provisions. In 12.5% of all cases, control over physical assets is granted to creditors directly, and in 55% of all cases, the firm is required to prepay bank debt with proceeds from divestitures. In three agreements creditors are given the right to hire, fire, or otherwise monitor managers directly. Although relatively small in number, these provisions are significant in that similar restrictions are not normally observed outside of financial distress. Although only one agreement allows creditors to attend meetings of the board of directors, this probably understates the frequency of such activity, given anecdotal evidence that creditors maintain an informal presence in the firm during most loan workouts [Salamon (1982), Stein (1989)].

Although these results are based on a sample of firms that restructure their debt outside of bankruptcy, they suggest extensive bank monitoring occurs in financially distressed firms. Evidence of creditors acquiring such extensive decision-making powers is largely absent in other studies that have examined the debt contracts of relatively healthy firms [Smith and Warner (1979), Castle (1980), McDaniel (1986)]. For example, Castle (1980) surveys the covenants contained in 37 bank term loan agreements for a sample of industrial and transportation companies rated by *Moody's*. Dividend restrictions appear in 23 of these agreements, 17 of which are rated Baa or lower. Total indebtedness is limited in 21 agreements, 17 of which are rated Baa or

[2]The language used in describing these covenants sometimes makes it difficult to distinguish cases in which a general restriction on the firm has become binding from cases in which creditors are granted an explicit veto over some aspect of the firm's investment and financing policies. When the latter situation unambiguously applies, 'creditor approval' is said to be required. Covenants are classified as 'general restrictions' when it is reported that the firm is 'unable' to undertake some activity (such as paying a dividend), but it is not clear that this results from the exercise of a creditor veto. Also classified as general restrictions are covenants that set a ceiling or floor on some variable, such as total long-term debt.

Table 4

Control exercised by creditors through inclusion of restrictive covenants in 40 privately restructured bank lending agreements, by general class of restriction. Sample is based on 50 exchange-listed firms that privately restructured their debt to avoid bankruptcy between 1979 and 1985. Figures are the percentage of restructured lending agreements that contain a given convenant.[a]

Description of covenant	Percentage
Restrictions on management activities	
Creditor approval required for changes in senior management or board of directors	2.5
Default declared if current CEO or chairman of the board leaves	2.5
Creditors permitted to attend board meetings	2.5
Restrictions on operating activities	
Maximum allowable outlay on general and administrative expenses	25.0
Increased financial reporting requirements to creditors	12.5
Creditor approval required for annual operating budget	7.5
Restrictions on new investment	
General restriction on level of capital expenditures	30.0
Restriction on permitted kinds of investment	22.5
Creditor approval required for capital expenditures	10.0
Maximum allowable cumulative investment in specified assets	5.0
Creditor approval required for mergers and other combinations	5.0
Restrictions on disposition of assets	
Creditors granted increased security interest in firm's assets	72.5
Restructured debt must be prepaid with proceeds of any divestitures[b]	55.0
General restriction on divestitures	22.5
Creditors granted ownership in assets directly	12.5
Restriction on firm's ability to collateralize assets	5.0
Creditor approval required for divestitures	7.5
Restriction on asset transfers to and from subsidiaries	10.0
Restrictions on payouts to shareholders	
General restriction on payouts[c]	37.5
Creditor approval required for dividends or share repurchases	47.5
Restrictions on financing activity	
General restriction on level of borrowing	50.0
Creditor approval required for any additional borrowing	15.0
Proceeds of new financings must be used to prepay restructured debt	7.5
New common stock must be sold as condition of debt restructuring	7.5
Creditor approval required for sale of new equity	2.5
Creditor approval required for redemption of subordinated debt	2.5
Financial covenants	
Minimum required current ratio or level of working capital	45.0
Minimum required net worth	40.0
Maximum debt-to-equity ratio[d]	17.5
Minimum required profitability[e]	12.5
Minimum permitted value of assets	7.5
Minimum permitted interest coverage	2.5
Minimum permitted level of net exports	2.5

[a]Sources used to identify covenants contained in restructured lending agreements include the *Moody's* manuals, the *Wall Street Journal*, and firms' 10k reports. Covenants characterized as general restrictions include cases where it is not possible to ascertain whether the restriction is actually binding when the restructuring agreement is consummated.

[b]Includes eight cases where divestitures are required as a condition of debt restructuring.

[c]Includes two covenants that require the firm to reinvest some minimum fraction of net income.

[d]Includes one covenant that requires the firm to maintain a minimum ratio of net worth to total assets.

[e]Includes two covenants that require the firm to maintain a minimum level of net income, two that specify a minimum level of net operating cash flows, and one that specifies a minimum accounting profit margin.

lower. Covenants that explicitly limit capital expenditures are present in only four agreements, all rated Baa or lower. No covenants are included that limit general and administrative expenses. Covenants that limit the granting of collateral to others are common, appearing in 34 agreements. Restrictions on the sale of assets are present in 29 agreements, but 19 of these are rated Baa or lower. In no case are creditors granted a veto over any of the firm's investment or financing activities, nor is there ever any requirement that assets be divested or that the proceeds from divestitures or new securities sales be used to prepay debt.

Another interesting comparison is provided by Baker and Wruck (1989), who document covenants in the bank loans that helped finance the 1986 leveraged buyout of O.M. Scott & Sons Company. They observe covenants quite similar to those reported in table 4 for financially distressed firms. For example, the company is prohibited from paying cash dividends, divesting major assets, and engaging in transactions (for example, mergers) that would change its 'corporate structure'; other covenants severely limit management's discretion over capital expenditures. Although LBOs and firms in financial distress both show high leverage (O.M. Scott & Sons had a book debt-to-assets ratio of 0.78 immediately following its LBO, compared with a median ratio of 0.83 for the present sample of companies), factors that contribute to high leverage are obviously much different between the two sets of firms. This suggests that direct creditor control over corporate policies in general increases with the relative importance of debt in the firm's capital structure.

Given evidence that creditors obtain increased property rights in the firm when it defaults, it remains an empirical question whether any resulting reallocation of resources is consistent with maximization of firm value. Attempts by creditors to maximize the value of their fixed claims can reduce the value of the firm's residual claims and total firm value [Jensen and Meckling (1976)]. This loss of value represents a potentially significant cost of financial distress that has not been previously emphasized in the bankruptcy literature. Although creditors' incentives to engage in such behavior can be reduced by giving them equity securities in the firm, the aforementioned institutional factors effectively preclude meaningful share ownership by creditors.

3.2. Monitoring by the board of directors

Under normal circumstances, managers' performance is monitored more or less continuously by the board of directors. I assess how directors' roles and responsibilities change as a result of financial distress by analyzing observed changes in the membership and composition of boards when firms renegotiate their debt contracts.

Although all directors can in principle monitor managers' performance, directors' backgrounds and affiliations will in practice affect their ability to monitor effectively. In the following analysis, directors are classified as outsiders, insiders, or quasi-insiders. Inside directors are also managers of the firm. Outside directors have no continuing personal or professional relationship with the firm other than in their capacity as directors. Quasi-inside directors have such a relationship, but are not managers. Examples of quasi-insiders are retired managers of the firm, relatives of current managers, and lawyers who also serve as the firm's counsel. A detailed description of the makeup of each class appears in table 6. Responsibility for monitoring management performance is commonly ascribed to the outside directors. Junior managers who are also inside directors will be reluctant to criticize senior managers on whom they depend for promotion. Quasi-inside directors who criticize management risk losing valuable business relationships with the firm. One common view is that inside and quasi-inside directors are brought onto the board for the valuable knowledge that they possess, and to advise and counsel the CEO [Mace (1986)]. In addition, inside directors can be potential candidates to succeed the CEO [Vancil (1987)].

Changes in board structure during financial distress are presented in table 5. Panel A documents how many of the directors in place one year before the start of a bankruptcy or debt restructuring remain on the board once their firms' financial distress has been resolved. These results are presented graphically in fig. 1. As discussed in section 2, reported turnover reflects only turnover that takes place while firms are financially distressed. For most firms in the sample, directors' tenure is tracked only until year +2, reflecting the mean time of approximately two years that these firms are financially distressed (see table 2).

Of 1,006 directors who initially sit on the boards of the 111 sampled firms, only 445 (46%) retain their seats at the end of the observation period. The corresponding turnover rate is similar for all three classes of directors. Thus, more than half the board turns over on average during a typical bankruptcy or debt restructuring. For 8% of firms in the sample the board is completely replaced (not shown). For 29% of the sample, less than one-fourth of the original directors remain. There is complete turnover of outside and inside directors in 24% and 25% of all firms, respectively. Less than 25% of the original directors in each of these classes remain at the conclusion of financial distress for 35% and 38% of sampled firms.

Consistent with the results of Gilson (1989), turnover among CEOs is also substantial. Only 44% of CEOs in place at year −1 are still employed in that capacity at year +4. In contrast, 55% of CEOs, all of whom initially hold a seat on the board of directors, retain their seat at the end of the observation period. At any given date, more incumbent CEOs remain on the board than stay CEO. That the ex-CEO is not removed from the board immediately

Table 5

Changes in the membership and structure of boards of directors during financial distress. Reported figures are based on information contained in firms' annual proxy statements and 10k reports. Sample consists of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985. Year 0 represents the date on which a firm either files for bankruptcy or starts to restructure its debt. Reported turnover includes only resignations that take place while firms are bankrupt or restructuring their debt.[a]

	Years elapsed relative to start of financial distress					
	−1	0	+1	+2	+3	+4
Panel A: Number (mean fraction) of directors and CEOs who remain with their firms						
Outside directors	517 (1.00)	427 (0.86)	334 (0.64)	270 (0.52)	243 (0.47)	237 (0.46)
Inside directors	370 (1.00)	306 (0.84)	233 (0.64)	177 (0.50)	161 (0.47)	157 (0.46)
Quasi-inside directors	119 (1.00)	108 (0.91)	76 (0.67)	63 (0.57)	54 (0.48)	51 (0.46)
All directors	1006 (1.00)	841 (0.85)	643 (0.65)	510 (0.52)	458 (0.48)	445 (0.46)
CEO (as director)	110 (1.00)	95 (0.86)	76 (0.69)	63 (0.57)	61 (0.56)	59 (0.54)
CEO (as manager)	110 (1.00)	91 (0.83)	66 (0.60)	49 (0.45)	47 (0.43)	47 (0.43)
Panel B: Mean (median) board size over time						
Number of directors	9.2 (8.0)	8.6 (8.0)	7.8 (7.0)	7.6 (7.0)	7.4 (7.0)	7.3 (7.0)
Panel C: Mean (median) percentage of board seats held by different classes of directors over time						
Outside directors	49.6 (50.0)	49.8 (50.0)	48.1 (50.0)	48.9 (50.0)	49.7 (52.3)	49.5 (54.6)
Inside directors	38.7 (40.0)	38.3 (40.0)	41.6 (41.4)	41.1 (40.0)	41.8 (40.0)	42.2 (40.0)
Quasi-inside directors	11.7 (9.1)	11.6 (10.0)	9.1 (0.0)	8.0 (0.0)	6.5 (0.0)	5.8 (0.0)

[a]Board turnover is assumed to take place on the date of the annual proxy statement that first reflects such turnover, unless a more accurate date can be established from reports of board changes in the *Wall Street Journal*. Outside directors have no other professional affiliation with the firm. Inside directors are also officers of the firm. Quasi-inside directors have some professional or family relationship with the firm, but are not insiders.

could reflect a certain amount of face saving or facilitate a smoother transition to new senior management [Vancil (1987)].

Turnover is fairly evenly distributed over the first three years of the observation period, with about 16% of incumbent directors and CEOs leaving each year. It does not appear that directors bail out before full public disclosure of their firms' financial problems. One possible explanation is that

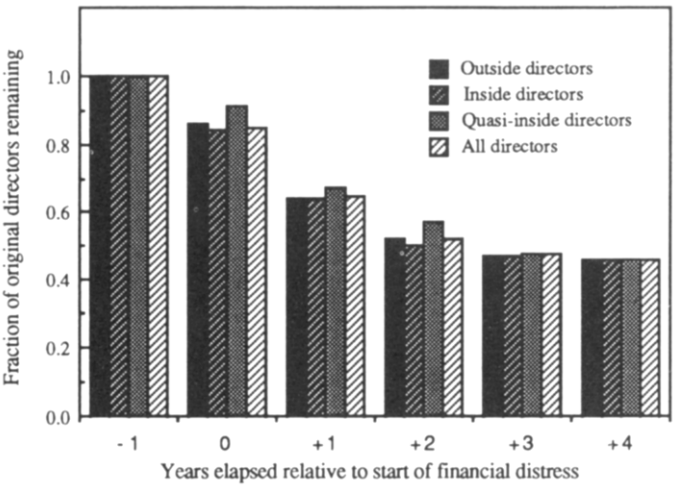


Fig. 1. Fraction of original directors who remain on the board, relative to date on which firm files for bankruptcy under Chapter 11 or begins to restructure its debt to avoid bankruptcy (year 0). Sample consists of 111 exchange-listed companies that either filed for bankruptcy (61 firms) or restructured their debt (50 firms) during 1979–1985. Outside directors have no other professional affiliation with the firm. Inside directors are also officers of the firm. Quasi-inside directors have some professional or family relationship with the firm, but are not insiders. Reported turnover includes only resignations that take place while firms are bankrupt or restructuring their debt.

directors could appear to be more culpable for their firms' financial problems, and increase their legal liability, if they depart from the board prematurely.

Although results are not presented for a control sample of non-financially-distressed firms, reported turnover of directors and CEOs in the sample appears to be large in relation to normal turnover. By comparison, Hermalin and Weisbach (1989) report turnover of approximately one director per year for an unconditional sample of 142 NYSE-listed firms during 1971–1983. The median board size in their sample is 13 directors, implying a 7.7% probability that any one director will leave the firm in a given year. Assuming that board departures are independent across directors and over time, 79% of the board should be still in place after three years. As reported in table 5 and fig. 1, only 52% of the original directors in the current sample remain by year +2. CEO turnover in financially distressed firms also appears to be much greater than that observed in normal situations. For example, Weisbach (1988) reports a mean annualized CEO resignation rate of 8% per firm for a sample of financially solvent NYSE firms. This implies a two-year cumulative departure rate of about 22%, compared with the observed rate of 55% for the present sample.

Panel B of table 5 reports changes in total board size throughout firms' financial distress. Over the entire period, the mean number of directors on the board declines from 9.2 to 7.3, and the median number from 8 to 7. Changes in both means and medians are statistically significant at the 1% level. Seventy-one firms, representing almost 60% of the sample, experience a decline in board size. For 36.7% of firms the decline in the total number of board seats exceeds 25%, and for 14.7% of firms the decline is greater than 50%. Declining board size in the sample is consistent with fewer directors being required to monitor the assets of financially distressed firms, either because assets are sold off to pay down debt or because substitute forms of monitoring arise in response to financial distress, such as monitoring by blockholders. Evidence presented below is consistent with such substitution taking place. Alternatively, financially distressed firms may be unable to attract people to serve as directors because of high expected legal and time costs associated with board service in these firms.

Additional insight into the nature of turnover is provided in panel C of table 5, which indicates that fractional board representation by different classes of directors does not change significantly during the debt renegotiation process. Both the mean and median percentages of outsiders on the board stay virtually unchanged at about 50%. The mean percentage of insiders on the board rises somewhat, but the difference is not statistically significant. The median percentage of inside directors is virtually unchanged, at 40%, throughout the period. In contrast, evidence presented by Hermalin and Weisbach (1988) for a sample of mostly large, solvent firms indicates that more outsiders are added to the board following poor operating performance. They interpret this shift as reflecting demand for greater monitoring of management induced by the firm's lack of profitability. In the present sample, the appointment of new outside directors is accompanied by the departure of incumbent outside directors, leaving board composition relatively unchanged.

3.2.1. Analysis of directors' characteristics

If firms become financially distressed because directors lack certain essential skills, or if new skills are required to manage such firms, we should expect to observe differences in the personal characteristics of departing directors and the directors who replace them. This possibility is examined in table 6. As shown in panel A, departing directors are older than their replacements. The mean age of departing directors is 58.1, whereas that of newly appointed directors is 51.4; corresponding median directors' ages are 58 and 52. Both means and medians are significantly different at the 5% level. Departing directors also appear to be relatively experienced, having served on their boards for 9.5 years on average (median of 7 years) before departing. Neither

departing nor newly appointed directors own very much common stock in their firms, with mean and median holdings for all types of directors of under 5%. None of the differences in stockholdings are statistically significant.

Panel B of table 6 presents a detailed breakdown of board departures and replacements, according to the identity of the directors involved. A comparison of the two columns indicates that financial distress is associated with a statistically significant increase in the proportion of outside board seats held by major blockholders, investment bankers, and representatives of the firm's creditors. The role of outside blockholders and investment banks in monitoring financially distressed firms is explored more fully below. Significantly fewer board seats are held by lawyers and former managers of the company. These comparisons suggest that financial distress engenders a shift towards greater board representation by outsiders who possess some special interest or expertise in monitoring financially distressed companies, even though the total proportion of outsiders on the board is unchanged.

3.2.2. Identifying the causes of board turnover

Evidence in tables 5 and 6 suggests that financial distress is accompanied by significant changes in board membership. This evidence has several possible interpretations, however. Directors could be forced to resign under pressure from stockholders because they are judged to have performed poorly in monitoring the firm's management. Board resignations in financially distressed firms could also occur at the urging of creditors; Gilson (1989) finds that bank lenders frequently initiate senior-management changes in financially distressed firms. Alternatively, directors could resign because they are inadequately insured against shareholder lawsuits, or because they are unable to replace an incompetent but powerful CEO, and wish to signal their dissatisfaction with current management [Macc (1986)]. In addition, directors could resign because of the personal trauma and time costs associated with serving on the board of a financially distressed firm.

In the context of understanding how financial distress affects corporate governance, the evidence on board turnover raises two important issues. First, as suggested by the preceding discussion, whether board resignations in financially distressed firms reflect disciplinary action against incompetent directors is an empirical question. If insolvency leads instead to the resignation or removal of 'good' directors, any resulting loss of firm value is a cost of financial distress.

The second issue concerns the possibility that board turnover in financially distressed firms is not caused by financial distress per se, but rather by the underlying decline in profitability that leaves the firm unable to service its debt. Recent evidence suggests that departures of senior managers [Warner et al. (1988), Weisbach (1988)] and directors [Hermalin and Weisbach (1988)]

Table 6

Selected characteristics of directors affected by board turnover. Turnover is identified by comparing firms' successive annual proxy statements, starting with the first proxy that predates the beginning of financial distress, and ending with the first proxy to follow the resolution of financial distress. Total turnover consists of 558 departures of directors whose incumbency predates the beginning of financial distress, and 417 appointments of new directors that follow the onset of financial distress. Sample consists of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985.[a]

	Departures	Appointments
Panel A: Mean (median) sample characteristics		
Age	58.1[b] (58[b])	51.4 (52)
Years served on board	9.5 (7)	—
Percentage common stock ownership		
(i) Outside directors	1.87 (0.09)	1.08 (0.00)
(ii) Inside directors	3.22 (0.52)	1.89 (0.08)
(iii) Quasi-inside directors	0.46 (0.01)	1.43 (0.00)
(iv) All directors	1.68 (0.05)	1.55 (0.00)
Panel B: Professional affiliation of directors (in %)		
Outside directors		
Appointed by creditors	0.0%[b]	0.9%
Manager in another nonfinancial firm	24.9	23.7
Manager in unaffiliated bank or insurance company	1.8	2.4
Retired manager of another company	4.1	2.4
Major blockholder in firm	8.3[b]	13.4
Investment banker	1.6[b]	3.8
Lawyer	3.7	3.8
Professor	3.7	2.4
Other	2.2	2.6
Inside directors		
Senior manager	15.9	17.2
Junior manager	20.8	20.9
Quasi-inside directors		
Lawyer affiliated with firm	4.4[b]	0.7
Investment banker affiliated with firm	0.9	1.7
Bank or insurance company lender of firm	1.2	0.7
Former manager of company	4.3[b]	0.7
Employee stock ownership plan (ESOP)	0.2	1.0
Relative of current manager	0.4	0.5
Other	1.9	1.2

[a]Board turnover is assumed to take place on the date of the annual proxy statement that first reflects such turnover, unless a more current date can be established from relevant stories in the *Wall Street Journal*. Outside directors have no other professional affiliation with the firm. Inside directors are also officers of the firm. Quasi-inside directors have some professional or family relationship with the firm, but are not insiders.

[b]Difference in means (medians) of departures and appointments is significantly different from zero at the 0.05 level using a two-tailed *t*-test (Wilcoxon rank sum test).

Table 7

Number of outside directorships subsequently held by directors who resign from the boards of companies that file for bankruptcy under Chapter 11 or privately restructure their debt to avoid bankruptcy. Sample consists of 160 directors of all types (including 67 outside directors) whose incumbency predates the beginning of financial distress. All resignations occur during the 1979–1985 period. Outside board memberships are obtained from various issues of Standard and Poor's *Register of Corporations, Directors and Executives*. Time 0 corresponds to the first calendar year-end predating a director's resignation date. Totals exclude seats held on the host company's board and on boards of host-company subsidiaries.[a]

	Number of outside directorships held in years following resignation			
	0	1	2	3
Outside directors				
Total	171	144	123	113
Mean	2.6	2.2	1.8	1.7
Median	1	1	1	1
All directors				
Total	350	308	270	226
Mean	2.2	1.9	1.7	1.4
Median	1	1	1	0

[a]Not counted as outside directorships are seats on the boards of nonprofit organizations, professional associations, and any firm in which the director also holds a management position. Multiple directorships in affiliated firms are treated as single directorships.

are more likely when firms' operating performance is poor. Although the following analysis does not control for the effects of poor performance, related evidence presented by Gilson (1989) suggests that financial distress independently engenders higher turnover among senior managers (the CEO, president, and chairman of the board). He observes a 52% annual turnover rate among senior managers for a large sample of financially distressed firms (including as a subset those analyzed here), compared with a rate of only 19% for a control sample of highly unprofitable, non-financially-distressed firms.

The relative infrequency with which board changes are reported in the *WSJ* makes it difficult to ascertain the reasons for turnover directly. Only 19.5% of all board departures and 37.6% of new board appointments are reported in the *WSJ*. In addition, firms' financial performance is cited in only six articles covering a board change. In two firms a majority of outside directors resigns following their companies' failure to obtain adequate directors' liability insurance. In one other case, all of the outside directors of a bankrupt company resign following the bankruptcy court examiner's recommendation that the directors be held legally liable for the company's problems.

Some indirect evidence on the reasons for board turnover is presented in table 7, which documents changes in the number of outside board seats that departing directors hold in other firms over the three years that follow their

departure. A decline in the number of other seats held is consistent with two explanations. If directors are held responsible for their firms' financial distress, their reputations as expert monitors will suffer, and they will be less often asked to serve on other boards. On the other hand, directors' experience with financial distress could be sufficiently unpleasant to discourage them from serving on other boards subsequently.

Information on board membership is obtained from Standard and Poor's *Register of Corporations, Directors and Executives* (henceforth, the *Register*). Of the 561 board resignations in total (see table 5), information on 160 directors is available in the *Register*. Only a subset of directors is represented in the *Register* because inclusion in this publication is voluntary, based on firms' response to a questionnaire. Financially troubled firms are less likely to be included if they have a lower response rate. Coverage of a particular director will continue as long as he or she sits on the board of at least one company that continues to report to the *Register*. Thus, the figures reported in table 7 will not be biased down unless the 160 directors analyzed in the table systematically hold seats in other firms that also become financially distressed (and stop reporting to the *Register*). Only departing directors' subsequent board service is analyzed, because directors who continue to serve with financially distressed firms could be forced to cut back on their other board commitments by time pressures. Separate totals are reported for outside directors and the entire board, recognizing that all directors can serve as outside directors in other companies.

At the resignation date, 160 directors of all kinds jointly hold a total of 350 outside board seats, excluding seats held on the board of the original host firm and any subsidiaries. Three years later, only 226 outside directorships are held, a decline of 35.4%. The corresponding decline for outside directors is 33.9%. Although the mean number of seats held by each director is small (2.2), the mean observed three years later is significantly lower (p-value less than 5%). Almost 36% of the directors represented in the table subsequently hold fewer other outside board seats, while only 11.9% of directors hold more seats after three years. These results are not sensitive to whether departing directors are close to retirement age, although board membership is generally not restricted by age. Both the absolute and percentage decline in the number of seats held remains significantly different from zero when the sample is restricted to directors younger than 55, 60, and 65 years. The partial correlation between the decline in number of board seats and age of departing directors is negative, but statistically insignificant. Kaplan and Reishus (1988) perform a similar analysis of outside board membership for CEOs of firms that implement large dividend reductions. However, they find no significant reduction in the total number of outside directorships held by CEOs.

Results in table 7 provide support for Fama and Jensen's (1983) conjecture that outside directors' principal compensation from serving on corporate

Table 8

Turnover of directors in firms with selected attributes. Total sample consists of 111 financially distressed New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985. Panels A and B report the mean fraction of incumbent directors who resign from the board within a given year and over the course of the firm's debt restructuring or bankruptcy, respectively.

Attribute	Sub-sample with attribute	Sub-sample without attribute	p-value of t-test for difference in means
Panel A: Mean fraction of incumbent directors who resign in a given year during firms' bankruptcy or debt restructuring			
Incumbent CEO resigns from board during the year	0.51	0.13	0.00
Incumbent CEO resigns as manager during the year	0.46	0.12	0.00
Panel B: Mean fraction of incumbent directors who resign over the course of firms' bankruptcy or debt restructuring (number of firms in parentheses)			
Incumbent CEO resigns as manager during the firm's bankruptcy or debt restructuring	0.67 (63)	0.36 (47)	0.00
Incumbent CEO is the firm's founder	0.53 (23)	0.54 (87)	0.85
Initial percentage of firm's common stock owned by managers and directors exceeds the sample median[a]	0.60 (50)	0.43 (49)	0.01
Firm's directors are elected for staggered terms	0.51 (29)	0.55 (81)	0.58
Firm privately restructures its debt as an alternative to bankruptcy	0.49 (50)	0.57 (60)	0.16

[a]Stock ownership by managers and directors equals beneficial ownership of stock reported in the firm's annual proxy statement that most closely predates the start of the bankruptcy or debt restructuring.

boards derives from the reputation they develop as expert monitors of management performance. Fama and Jensen argue that the impact of board service on directors' wealth will be greater 'when the direct payments to outside directors are small, but there is substantial devaluation of human capital when internal decision control breaks down and the costly last resort process of an outside takeover is activated (p. 315)'. In the absence of this incentive, it is difficult to understand what financial incentives directors have to perform in their delegated role as monitors, since they typically own very little common stock in the companies on whose boards they serve and are paid only a fixed, nominal fee for board service.

Table 8 presents additional indirect evidence on the causes of board turnover in financially distressed firms. Evidence in panel A tests the hypothesis that if directors are blamed for having failed to preempt bad management decisions (that resulted in financial distress), turnover of directors

should be positively correlated with turnover of the CEO. This correlation will also be positive if creditors replace both managers and directors in financially distressed firms. If directors resign for other reasons (for example, to avoid further trauma due to financial distress or to express their displeasure with an incompetent but powerful CEO), the observed correlation should be zero or negative. Panel A shows that the mean fraction of directors who resign from the board in a given year is significantly higher in years when the CEO also resigns (in his or her capacity as either director or manager). Fifty-one percent of all directors leave in years when the CEO resigns from the board, compared with only 13% of directors in other years. As shown in panel B, 67% of incumbent directors resign over the entire course of firms' financial distress when the CEO also resigns, compared with only 36% for firms where the CEO remains. All of these differences are statistically significant at the 1% level.

Table 8 also presents evidence on how other firm attributes affect turnover of directors. Board turnover is unaffected by whether the CEO is the company's founder, which has been suggested as one measure of his or her power [Morck et al. (1988)]. Turnover is significantly higher when insider stock ownership exceeds the sample median, and is not significantly lower when directors' terms are staggered. These results suggest that conventional means available to managers and directors for self-entrenchment are relatively ineffective when firms are financially distressed.

Finally, board turnover appears to be lower when debt is restructured privately rather than in Chapter 11, although the difference is not statistically significant. Fifty-seven percent of directors resign in firms that file for bankruptcy, compared with 49% of directors in firms that restructure their debt privately; corresponding median percentages (not shown) are 62% and 52%. A t-test and Wilcoxon rank-sum test fail to reject the hypothesis of no difference in means and medians. Self-interest of directors would therefore not appear to be a critical factor in whether firms file for bankruptcy or attempt to settle privately with creditors. It may not be possible to generalize from such comparisons, however, because of the relatively small sample size. In addition, directors who assess a greater risk of turnover due to bankruptcy will be predisposed to settle with creditors privately (assuming that this option still exists), and their firms will be less likely to file for bankruptcy. This selection bias implies that actual turnover observed in bankrupt firms will be an underestimate of expected turnover due to bankruptcy.

Results of the univariate comparisons in table 8 are confirmed when cumulative turnover rates (reported in panel A of table 5) are related to these variables jointly in ordinary-least-squares regressions (not shown). Separate regressions are estimated for turnover of all directors and turnover of directors within each class (outside, inside, and quasi-inside). Cumulative turnover of all three kinds of directors is positively and significantly related to

whether the firm's CEO resigns during the financial distress (p-value less than 0.01). None of the remaining coefficient estimates are statistically significant. These results are largely unchanged when measures of the firm's past profitability are included as explanatory variables, including cumulative common stock returns and unexpected annual earnings before interest and taxes (as defined in table 2). For various lags, these performance variables are almost always statistically insignificant. There is weak evidence that staggered boards are associated with lower turnover when regressions include firms' unexpected annual earnings (p-value of 0.11). The multivariate results are otherwise consistent, however, with the results in table 8.

3.3. *Monitoring by outside blockholders*

Concurrently with the changes in board structure, there appears to be a significant increase in large blockholdings in the sample. This is consistent with an increased monitoring role for external blockholders and other outsiders in financially distressed firms. Panel A of table 9 presents mean and median percentage common stock ownership of blockholders over the same period used to measure board turnover. Changes in total blockholdings are also illustrated graphically in fig. 2 (panel A). Because firms depart from the sample once they emerge from bankruptcy or conclude a debt restructuring agreement, the sample size declines significantly in years +3 and +4. Because most firms are tracked at least until year +2, ownership figures for this year are potentially the most meaningful.

Exclusive of holdings by managers and directors, the mean percentage of common stock held by all blockholders – defined as those holding stakes of more than 5% – increases from 12.34% in year −1 to 27.89% in year +2, and to 28.69% in year +4. Corresponding median ownership percentages are 0.00%, 23.90%, and 26.50%. Increases in block ownership through year +3 (relative to year −1) are all statistically significant using a paired-comparison t-test for means and a Wilcoxon signed-rank test for medians. These tests both make pairwise comparisons of ownership between years, to allow for the declining sample size over event time. Mean percentage holdings by the largest beneficial owner increase from 9.62% in year −1 to 18.23% in year +2, although mean holdings fall to 8.67% by year +4. A similar pattern is observed for median holdings. Mean and median ownership by the largest blockholder is significantly higher in each year through years +2 and +3, respectively. These results offer an interesting contrast to those of Loderer and Sheehan (1989), who find that percentage stock ownership by outside blockholders (and corporate insiders) changes very little over the five years that precede bankruptcy.

Increases in percentage blockholdings also appear to be accompanied by increases in board representation, although the relationship is weak. Table 9

Table 9

Percentage ownership of common stock in financially distressed firms, by various classes of holders and by years relative to the beginning of financial distress. Sample consists of 111 New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985. Year 0 represents the date on which a firm either files for bankruptcy or starts to restructure its debt. The sample size declines over time because of unavailability of data and departures of firms from the sample as they complete their bankruptcy or debt restructuring before year +4. The statistical significance of the difference in mean and median ownership percentages (relative to ownership in year −1) is determined using a paired-comparison t-test and a Wilcoxon signed-rank test, respectively.[a]

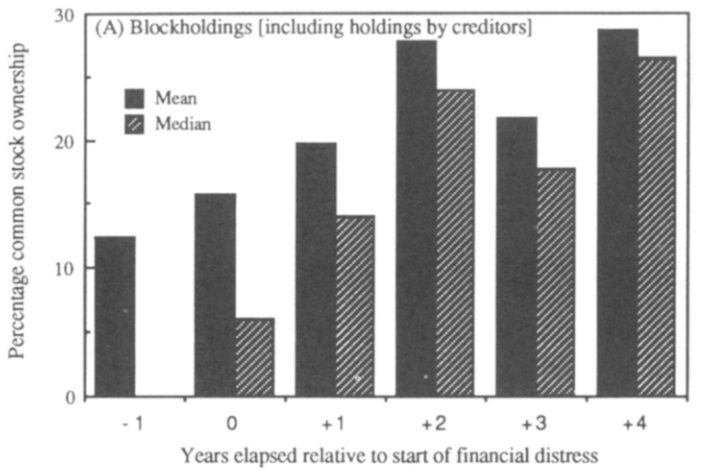
Stockholder	Mean and median percentage ownership in years elapsed relative to start of financial distress					
	−1	0	+1	+2	+3	+4
Panel A: Ownership by nonmanagement blockholders						
All > 5% blockholders	12.34	15.74[c]	19.76[b]	27.89[b]	21.87[d]	28.69
	0.00	5.95[c]	14.10[b]	23.90[b]	17.70[d]	26.50
Mean and median % of board seats held	*5.0*	*5.0*	*7.9*	*12.5*	*3.6*	*1.2*
	0.0	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Largest > 5% blockholder	9.62	12.28[c]	14.59[b]	18.23[b]	11.79	8.67
	0.00	5.60[c]	9.30[b]	14.40[b]	11.00[d]	8.65
Mean and median % of board seats held	*4.4*	*4.1*	*6.0*	*10.4*	*2.2*	*0.0*
	0.0	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Panel B: Ownership by corporate insiders						
Outside directors	3.21	1.62	3.73	4.26	2.34	1.28
	0.29	0.20[c]	0.35[c]	0.17	0.04	0.34
Inside directors	16.80	16.44	11.01[c]	10.96[c]	13.18	1.10
	9.18	10.07[d]	5.00[b]	6.09[b]	2.37[c]	0.85
Quasi-inside directors	0.75	1.17	0.59	0.54	0.46	0.07
	0.01	0.01	0.00	0.00	0.00	0.05
CEO	10.52	10.09	7.53[c]	6.41[c]	6.66	0.92
	4.30	4.22	1.99[c]	1.69[b]	1.00[c]	0.54
All officers and directors	21.91	20.52	16.02[d]	16.52	16.54	2.88
	14.30	14.55[d]	11.59[b]	10.54[b]	4.95[c]	2.61
Sample size	103	92	77	75	25	4

[a]Ownership percentages in the table represent holdings reported in the annual proxy statement that most closely predates a given event year. Outside directors have no other professional affiliation with the firm. Inside directors are also officers of the firm. Quasi-inside directors have some professional or family relationship with the firm, but are not insiders.

[b]Ownership percentage is significantly different from percentage in year −1 at the 0.01 level.

[c]Ownership percentage is significantly different from percentage in year −1 at the 0.05 level.

[d]Ownership percentage is significantly different from percentage in year −1 at the 0.10 level.



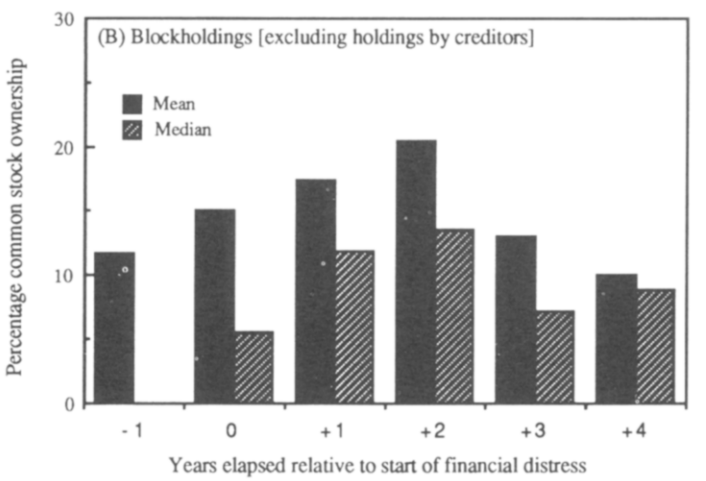


Fig. 2. Mean and median percentage of common stock held by all nonmanagement blockholders, relative to year in which firm files for Chapter 11 or begins to restructure its debt to avoid bankruptcy (year 0). Blockholders are defined as owners of more than 5% of the firm's common stock, including (A) and excluding (B) creditors. Creditors consist of banks, insurance companies, ESOPs, and other corporate lenders. Sample consists of 111 exchange-listed companies that either filed for bankruptcy (61 firms) or restructured their debt (50 firms) during 1979–1985.

indicates that blockholders on average hold 12.5% of the board seats in the companies whose stock they hold in year +2, compared with 5% of the seats in the initial year. Corresponding percentages for the largest blockholder are 10.4% and 4.4%. For both categories of holdings, however, the median percentage of seats held is zero throughout the entire interval. Thus, blockholders' ability to influence corporate policy in these firms does not appear to require majority representation on the board.

Increased ownership concentration in the sample is not simply a consequence of increased equity ownership by creditors. Panel B of fig. 2 graphs mean and median percentage holdings of all blockholders exclusive of holdings by creditors. Although levels of ownership are reduced by this adjustment, the same general pattern of changes in ownership concentration is observed as in panel A for the full sample of blockholdings, except for the last two years. The statistical tests described above both reject at the 5% level the hypothesis of no increase in percentage ownership for years +1 and +2. Blockholdings are noticeably less in years +3 and +4 when holdings by creditors are removed, but these declines are not statistically significant, reflecting the small sample size for these years.

A similar analysis suggests that increased blockholdings in the sample are not driven by private equity placements, but rather reflect the consolidation of blocks out of existing shares. Each firm in the sample was examined in the *WSJ Index* over the entire event period for any mention of private equity placements. This search yielded 13 such placements, but the patterns evident in table 9 and fig. 2 do not materially change when the impact of these placements on stock ownership is excluded.

At the same time as external holdings increase in importance, stock ownership by corporate insiders, and the board of directors, declines. Data on directors' stockholdings are presented in panel B of table 9 and illustrated in fig. 3. Holdings by outside and quasi-inside directors generally do not change significantly over the event period. Mean percentage ownership of inside directors falls from 16.80% in year −1 to 10.96% in year +2 and 1.10% in year +4; corresponding median holdings by inside directors are 9.18%, 6.09%, and 0.85%. Mean holdings by inside directors are significantly lower in years +1 and +2, and median holdings are significantly lower in each year through year +3. The same general results hold for stockholdings by all officers and directors.

This observed decline in inside ownership is somewhat puzzling, given that the incentive-related benefits of compensating managers with company stock are likely to be greatest when a firm is unprofitable [Jensen and Meckling (1976), Baker et al. (1988)]. Arguing that managers are unwilling to hold equity in these firms because of a lack of diversification does not provide a completely satisfactory explanation. Although stock-return variances are higher for financially distressed (highly levered) firms, the dollar value of

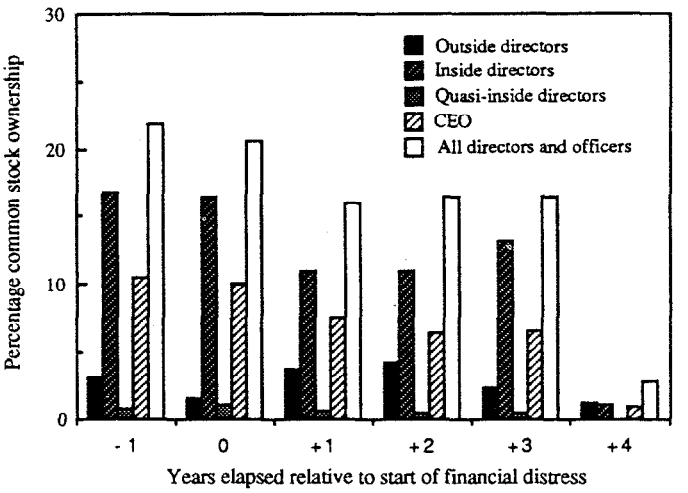


Fig. 3. Mean percentage of common stock held by directors and officers, relative to year in which firm files for Chapter 11 or begins to restructure its debt to avoid bankruptcy (year 0). Sample consists of 111 exchange-listed companies that either filed for bankruptcy (61 firms) or restructured their debt (50 firms) during 1979–1985. Outside directors have no other professional affiliation with the firm. Inside directors are also officers of the firm. Quasi-inside directors have some professional or family relationship with the firm, but are not insiders.

stock outstanding for these firms, and thus induced changes in managers' total wealth, will be relatively small.

Evidence that blockholdings increase in importance when firms become extremely unprofitable or insolvent is consistent with the view that the discipline imposed by blockholders substitutes for monitoring by the board when the latter fails to preempt bad management decisions [Fama (1980), Fama and Jensen (1983)]. Empirical support for this view of blockholders is provided by Barclay and Holderness (1989), who find that announcements of negotiated block trades of common stock are associated with positive average abnormal stock returns of about 15%. For the present sample of financially distressed firms, larger blockholdings are more likely to be associated with greater monitoring of insiders' performance, because such blocks result largely from the consolidation of existing shares rather than private placements of new equity. Private placements, which are initiated by corporate insiders, can be structured to concentrate voting power in friendly hands, and result in less monitoring of insiders' performance [Dann and DeAngelo (1988), Wruck (1989)].

Alternatively, blockholdings in financially distressed firms may be formed for some other purpose than to facilitate increased monitoring of management or bring about substantive changes in corporate policy. For example,

blocks of distressed firms' securities could be passively held by contrarian investors who believe that such securities are underpriced. Alternatively, some investors could perceive a strategic advantage to consolidating large blocks of stock (or other securities) to obtain a more generous distribution under the firm's bankruptcy or debt restructuring plan. Both forms of so-called vulture investing have lately received extensive coverage in the financial press [Sandler (1989)]. Finally, incentives exist to consolidate securities of financially distressed firms into blocks to conserve on transactions costs of renegotiating the firm's debt, if such costs are an increasing function of the number of claimholders [Gilson et al. (1990)].

One way of assessing the motives for blockholdings is to consider the identity of the blockholders. Table 10 reports the identity of major blockholders in the sample, as shown in firms' proxy statements. Figures in the table are the percentages of firms in the sample for which the largest blockholder falls in a particular class.[3] Over event time there is a statistically significant increase in the percentage of blockholdings owned by bank or insurance-company lenders and nonfinancial corporations. Bank and insurance company lenders are major blockholders in 3.0% of firms in year -1 and in 18.7% of firms in year $+2$. Corresponding percentages for nonfinancial corporations are 10.8% and 22.7%. Unfortunately, it is impossible to ascertain the blockholder's identity in about 25% to 50% of all cases, since proxies must disclose the name, but not the identity, of major holders.

3.4. Monitoring by investment banks and workout specialists

Consistent with evidence on replacement directors' characteristics reported in table 8, monitoring of financially distressed companies is often performed by those with expertise in managing highly levered firms or dealing with creditors. Investment banking firms are formally involved in the debt renegotiation process for 27 firms in the sample. The majority of these investment banks have acquired reputations as specialists in corporate turnarounds, including Bear Stearns (12 firms), Drexel Burnham Lambert (10 firms), Oppenheimer (2 firms), Lazard Freres (1 firm), Rothschild (1 firm), and Hambrecht and Quist (1 firm). Seven investment banks also acquire seats on the board of directors, holding a total of 21 seats on the boards of 16

[3]Figures are based on largest, rather than total, blockholdings because I wanted reported percentages to reflect the importance of certain types of blockholders relative to the total number of *firms* in the sample. Basing the percentages instead on the *total number* of blockholdings could potentially misrepresent the likelihood that a particular type of blockholding will arise in a financially distressed firm. For example, suppose that the sample were to consist of only two firms, that only a single blockholding existed for the first firm (held by a bank), and four blockholdings existed for the second (held by four nonfinancial corporations). Nonfinancial corporations would be holders of 80% of all blocks, but would be blockholders in only 50% of all firms.

Table 10

Changes in the identity of blockholders during financial distress. Sample consists of 111 financially distressed New York- and American Stock Exchange-listed firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1979 and 1985. Figures in the table are the percentage of firms in the sample whose largest outstanding blocks of common stock are held by various classes of holders. All blocks exceed 5% of a firm's outstanding shares. Year 0 represents the date on which a firm either files for bankruptcy or starts to restructure its debt. Sample size declines over time because of unavailability of data and through departures of firms from the sample as they complete their bankruptcy or debt restructuring before year +4. All firms are tracked at least until year +2. The statistical significance of the difference in percentage representation of blockholders (relative to representation in year −1) is determined using a two-tailed *t*-test.[a]

	Percentage of firms whose largest blocks are held by various classes of holders in years elapsed relative to start of financial distress					
Blockholder	−1	0	+1	+2	+3	+4
Bank or insurance company	3.0	2.2	7.8	18.7[b]	28.0[c]	25.0
Nonfinancial corporation	10.8	17.6	20.8[d]	22.7[c]	24.0	0.0[b]
Other creditors	3.0	2.2	0.0[d]	2.7	4.0	0.0[d]
Investment bank	1.0	0.0	2.6	4.0	4.0	0.0
Mutual fund or investment company	8.8	8.8	10.4	5.3[c]	0.0[c]	25.0[c]
Pension fund	0.0	0.0	1.3	0.0	0.0	0.0
Employee stock ownership plan	2.0	3.3	3.9	1.3	4.0	0.0
Individual investor	2.9	4.4	3.9	6.7	4.0	0.0[c]
Nominee ('street') holder	5.9	4.4	5.2	4.0	0.0[c]	0.0[c]
U.S. government	0.0	0.0	1.3	0.0	0.0	0.0
Subsidiary of company	1.0	1.1	1.3	1.3	0.0	0.0
Estates and family trusts	9.9	12.1	7.8	6.7	0.0[c]	0.0[c]
Unknown	52.0	44.0	32.5[b]	26.6[b]	32.0[c]	50.0

[a]Figures in the table are based on information contained in firms' annual 10k reports and proxy statements. 'Other creditors' includes trade creditors, factoring companies, and other nonfinancial corporations.

[b]Percentage is significantly different from percentage in year −1 at the 0.01 level.

[c]Percentage is significantly different from percentage in year −1 at the 0.05 level.

[d]Percentage is significantly different from percentage in year −1 at the 0.10 level.

companies. Eleven firms bring in new senior managers who specialize in managing financially troubled companies. Among the more notable crisis managers in the sample are Victor Palmieri, Sanford Sigoloff, and Q.T. Wiles. Another manager, William Scharffenberger, is at different times the CEO of three companies in the sample.

3.5. *Corporate takeovers*

Interestingly, despite evidence that hostile takeovers are more likely to occur when firms have been performing poorly [Morck et al. (1988)], very few firms in the sample are involved in any sort of takeover-related transaction.

An exhaustive search was made in the *WSJ Index* and firms' 10k reports and proxy statements for any evidence of these transactions during the event period. This search yielded only two firms that became the target of an attempted hostile takeover. Five firms were involved in proxy fights in which dissidents sought representation on the board; in two cases they won. Two additional firms adopted antitakeover amendments. In twelve cases a bankruptcy or debt restructuring concluded with the firm being acquired in a friendly merger. One possible explanation for the paucity of takeovers in the sample is that bank creditors, who are made extremely powerful by a default, can effectively block any merger that threatens to diminish their control over the firm's assets.

4. Summary and conclusions

This paper investigates changes in corporate ownership and control in firms that default on their debt. For a sample of 111 publicly traded firms that either went bankrupt or privately restructured their debt, I find evidence consistent with a shift in control over corporate resources from incumbent management and the board of directors towards nonmanagement blockholders and creditors. On average, only 46% of incumbent directors and 43% of CEOs remain with their firms at the conclusion of the bankruptcy or debt restructuring. Directors who resign from financially distressed firms subsequently serve on fewer boards of other companies. Over the period that firms are financially distressed, the percentage of common stock owned by blockholders and creditors rises. Bank lenders sometimes place their representatives on the board directly. Banks gain additional control over firms' investment and financing policies through restrictive covenants in restructured bank loans. Collectively, these results suggest that corporate default engenders significant changes in the ownership of firms' residual claims and in the allocation of rights to manage corporate resources.

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