Financial distress, bank debt restructurings, and layoffs

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Abstract. We develop a model of a financially distressed firm to analyze the implications of a bank debt restructuring when the operational characteristics of the firm’s project for the post-distress period are endogenously determined as part of the workout. We establish a formal link between the debt restructuring and operational actions such as employee layoffs, and show how these actions are affected by the firm’s capital structure, the ordering of absolute priorities, and the allocation of control rights and residual claims after reorganization. Finally, we discuss the implications of our analysis for the design of reorganization law.

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1 Introduction

There is by now an extensive literature suggesting that the firm’s capital structure, the ordering of absolute priorities in case of liquidation, and the allocation of control rights and residual claims after reorganization, all play a determinant role for the outcome of any debt restructuring process involving firms in financial distress. Most theoretical studies, among which Bulow and Shoven (1978) and
Gertner and Scharfstein (1991) are leading examples, have focused on the analysis of the efficiency of bank debt restructurings under the assumption that the only issue under negotiation between the distressed firm and its creditors is whether the firm is allowed to continue in operation or, otherwise, is liquidated.

At the empirical side, however, some recent studies have documented that within voluntary workouts numerous and important operational changes are imposed upon firms allowed to continue in operation. In particular, these studies find that there are significant asset sales and employee layoffs from the pre-distress period, and that many CEOs of distressed companies are replaced after restructuring. Some of these changes, such as asset sales and business divestitures, may be simply undertaken to raise cash and repay part of the outstanding debt. But some others, which only affect the firm’s future revenue stream but not its current liquidity, such as the replacement of CEOs and employee layoffs not associated with plant closings, cannot serve this purpose.

An illustrative example of operational changes like these is provided by Gilson (1997, 1998). He analyzes the corporate downsizing program undertaken by the Scott Paper Company. Scott Paper was the larger producer of consumer tissue products in the world. Its workforce comprised over 30,000 people. From 1988 to 1993 the company’s profits fell dramatically from profits of $376 million to a net loss of $277 million. In 1994, Standard and Poor’s downgraded Scott’s public bonds and the firm was considered to be in financial distress. A new CEO, Alfred J. Dunlap, was appointed in 1994 to stop the company’s slide.

“In less than a year, Dunlap oversaw the elimination of almost one-third of the company’s 34,000 hourly and salaried employees, through layoffs and asset sales. By the end of the restructuring in late 1995, when Scott was acquired by Kimberly-Clark, the value of Scott’s common stock had increased by more than $3 billion (over 200%). Dunlap’s personal wealth increased over this period by nearly $100 million, reflecting his compensation and appreciation of his Scott stock holdings and executive stock options.” (Gilson, 1998, p. 20.)

Largely unaddressed is the extent to which these operational changes are meant to increase the efficiency of the firm’s investment project, or else they simply reflect the conflicting viewpoints of the various stakeholders of the firm and the change in their relative bargaining powers that is brought by financial distress. Also unstudied is the issue of how these operational actions are affected by the firm’s capital structure, the ordering of absolute priorities, and the allocation of control rights and residual claims after reorganization.

In order to shed some light on these matters, we develop a simple model of a financially distressed firm with three kinds of claimholders: shareholders,

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1 As regards to CEO turnover, see Gilson (1989) and references therein. Concerning employee layoffs, see, among others, Asquith et al. (1994), DeAngelo and DeAngelo (1991), John et al. (1992), Ofek (1993), Opler and Titman (1994), and Sharpe (1994). DeAngelo and DeAngelo (1991), for instance, find that 2/3 of the work force was laid off during the 1980 restructuring of the U.S. steel industry. For evidence on employee layoffs in financially distressed Spanish firms, see Requejo (1996).