

The impact of the LaSalle Judgement on Share Price Reactions

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ABSTRACT

The Supreme Court in LaSalle acknowledged an exception to the “Absolute Priority Rule” for “new value contributions” on condition of a “market test”. This study examined the impact of the “market test” on share price reactions with regard to Chapter 11 bankruptcy filings in the United States. This study found that the share price reactions were stronger for the period after LaSalle. However, the effect of the “market test”, determined by my model, was not statistically significant. The results suggest that future research on the “market test” should use a channel which is more directly linked to “absolute priority deviations”.

Keywords

Chapter 11, bankruptcy, LaSalle, share price reactions.

INTRODUCTION

On May 3 1999 the Supreme Court made an unexpected judgement in the case of the Bank of America v. 203 North LaSalle Partnership. The Supreme Court granted permission for a deviation to the “absolute priority rule”(APR)¹ with respect to the old equity holders who in exchange for a sufficient value contribution could retain their equity after the firm emerges from Chapter 11 bankruptcy. However, only on the condition that a “market test” would be conducted. Deviations from the APR in favor of equity holders was not a rare occurrence, however the condition concerning a “market test” was unexpected. It implied that equity holders could lose their equity by means of an auction or a competing plan.

To my knowledge, only Giambona, Lopez-de-Silanes and Matta (2014) examined the market performance around the Supreme Court Ruling. They expected to find that the “market test” would increase funding availability due to the increased asset verifiability. The hypotheses was supported by their findings as a significant positive cumulative average abnormal return of 1.62% was found five days surrounding the judgement.

My research contributes to previous economic literature by examining the impact of the “market test” for the “new value contribution” on share price reactions. Instead of conducting one event study, like Giambona et al, I

conducted an event study for each Chapter 11 filing and compared the market reactions for the period before and after the judgement in LaSalle.

LITERATURE REVIEW

Guy (2012) plead that the judgement of the Supreme Court in LaSalle made debtors reluctant to file for Chapter 11. He argued that the “market test” makes retaining a stake in the firm uncertain and therefore risky, because the shareholders could lose their equity in an auction. Moreover, successfully restructuring outside Chapter 11 is more difficult due to the fact that the threat of filing for Chapter 11 is less credible. Therefore, the equity holders prefer to walk away and sell their assets rather than running a risk (Guy, 2012). The requirements imposed on the “new value contribution” makes Chapter 11 even less attractive for small and medium sized firms, since it is not likely that their shareholders own valuable assets equal to the market value of their claim (Markell, 2000).

Hence, I expect that the foresight of a “market test” causes self-selection, which means that firms only file for Chapter 11 when they expect their chances of emerging and retaining (part of) the equity is high. Therefore, I expect to find relatively higher, but still negative, returns for firms that filed for Chapter 11 after the judgement compared to those who filed before the judgement. Furthermore, small and medium sized firms would rather go for a sale or an out of court solution than file for Chapter 11 as the risk of losing the equity will probably be higher for these firms. Thus, I also expect to find that the firms filing for bankruptcy after the judgement will be larger in size.

DATA

This study analysed bankruptcies of businesses covered by the US legislation. The UCLA-LoPucki Bankruptcy Research Database (BRD) was used to collect Chapter 11 bankruptcy events and the Compustat database was used to collect accounting and stock data. Additionally, the Equal-Weighted Returns (including distributions) were retrieved from CRSP Stock Market Indexes, and the Fama and French (1993) factors were retrieved from Fama-French Portfolios and Factors.

¹ The APR entails that no junior claimant will be paid before all senior classes are paid in full.

Sample selection

This research focussed on the event of bankruptcy. Panel data from Chapter 11 cases were collected and divided into two samples. The first sample covered the period January 1990 up to May 2 1999 and the second sample covered May 3 1999 up to 2013. The judgement in LaSalle was unexpected and it is therefore assumed that the daily stock returns in sample 1 do not reflect this judgement.

Financial firms were excluded from the samples, due to the fact that they are treated differently under the US bankruptcy legislation².

An event study was conducted for each Chapter 11 filing in the sample. Prior research on bankruptcies used announcement windows equal to [-1,+1] trading days, because firms can file for bankruptcy after the market closes (Dawkins, Bhattacharya & Bamber, 2007). Therefore, investors cannot always immediately react on bankruptcy news. In this study an announcement window of [-1,1] trading days was also applied. The event window was set to one month or 21 trading days. The reason behind the chosen width of this event window was so that it would not include more than one event as some firms file for bankruptcy more than once.

Furthermore, to minimize the cross sample correlation the method used by Cox and Peterson (1994) was applied³. Additionally, only the first filing was included per sample. This means that a firm can only appear once in each of the two samples, but can appear twice in the total sample. The total sample consisted of 310 events, including 92 events before and 218 events after the LaSalle case.

METHODOLOGY

First the daily returns were calculated for every firm starting with 20 trading days before the bankruptcy date. The following formula was used:

$$R_{it} = \log(R_t) - \log(R_{t-1}) \quad (1)$$

After calculating the returns, the returns were adjusted for the stock market returns. Instead of using normal returns calculated with, for example, CAPM the returns were adjusted for the daily Equal-Weighted Returns (EWRET). EWRET (R_m) was used because the company betas change before bankruptcy (Coelho & Taffler, 2008). Dawkins, Bhattacharya and Bamber (2007) pointed out that firms that file for bankruptcy generally have a lower median assets value and therefore the Equal-Weighted Returns should be used instead of the Value-Weighted Returns from the market index. These adjustments were incorporated in Formula 2.

$$AR_{it} = R_{it} - R_{mt} \quad (2)$$

² Financial firms were classified as firms with a Standard Industrial Classification (SIC) code between 6000 and 6999.

³ This method entails keeping only the first observation, after sorting on trading day and firm names, when more than one event takes place on a specific trading day.

After calculating every AR, the CARs were calculated using the standard event study method.

$$CAR_i = \sum AR_{it} \quad (3)$$

The average of the CARs was used to obtain the cumulative average abnormal return (CAAR). In line with earlier bankruptcy studies, the CAARs were tested for significance using a parametric t-test and a nonparametric Wilcoxon rank-sum test (Rose-Green & Dawkins, 2002).

Additionally, a regression was conducted to assess the effect of the “market test” on the cumulative abnormal return from companies who filed for Chapter 11. The following model was used:

$$CAR_{it} = b_0 + b_1MarketTest + b_2Zscore + b_3BookLeverage + b_4LN(MVEQ) + b_5SMB + b_6HML + b_7UMD + b_8\sum(Industry) + Year_i + e_{it} \quad (4)$$

MarketTest = dummy variable for fiscal year. Where 0 represents 1990 – 2 May 1999 and 1 represents 3 May 1999- 2013

Zscore = Z-score measured for the fiscal year end before the bankruptcy filing

Bookleverage = total debt divided by the book value of total assets

MVEQ = market value of the equity for the fiscal year end before the bankruptcy filing

SMB = small minus big

HML = high minus low

UMD = up minus down

Industry = six dummy variables for the major divisions from the Standard Industrial Classification (SIC)

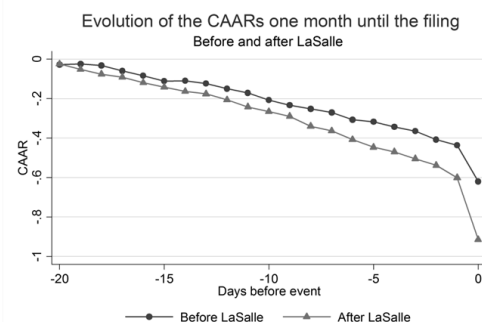
Year_i = fixed effect for time, where i starts at 1989 and goes up to 2013

RESULTS

Univariate analysis

To provide a general overview of the market reactions to Chapter 11 filings in the periods 1990 until May 2 1999 and May 3 1999 until 2013, the evolution of the CAARs are presented in Figure 1. The CAARs are the cross sectional average of the CARs per day in the event window. Figure 1 shows negative CAARs for the period before as well as after the judgement in LaSalle. This finding is supported by previous bankruptcy studies who also found negative CARs before the Chapter 11 filings. Furthermore, Figure 1 indicates a relative larger decline in CAARs for the period after LaSalle. This decline is especially visible on the day of filing (day zero) as the CAAR on the filing day covering the period before LaSalle equals -0.6198 (-61.98%) and after LaSalle equals -0.9143 (-91.43%).

Figure 1



The second analysis addressed the question whether the CAARs differed significantly from each other. First of all, the CAARs across the event window were tested with a t-test on their significance. Afterwards the CAARs were compared and checked on their significance by conducting another t-test and a Wilcoxon rank-sum test. The results of this analysis are presented in the Appendix.

[Insert Table 1]

Contrary to my expectations, the results in Table 1 show that the firms who filed for Chapter 11 after the judgement have a more negative CAAR than the ones before LaSalle. Both the t-test and the Wilcoxon rank-sum test pointed out that the CAARs differed significantly, with a difference equal to 0.085. A possible explanation for this finding is that firms who file for bankruptcy after the judgement tried to avoid bankruptcy, but still ended up filing for Chapter 11 bankruptcy. It is likely that these firms entered bankruptcy in a worse condition. Entering Chapter 11 in this condition will negatively influence the expected chance of emerging from Chapter 11 and thus increase the chances of losing the equity. This results in a relatively larger price drop as shareholders try to sell their shares. Bharath et al (2013) had a similar line of thought, which corresponded with my explanation. They proved that the increased power of creditors resulted in managers trying to avoid Chapter 11 for as long as possible as they anticipated their reduced bargaining power.

The final analysis, a descriptive analysis, was conducted to examine if the companies that filed for Chapter 11 after LaSalle were indeed in a worse condition. The results are displayed in Table 2 in the Appendix. Both samples had Z-score below 1.81, which shows that they were bankrupt (Altman, 1968). The significantly lower Z-score, calculated for the end of the fiscal year prior to the filing, supports the expectation that firms after LaSalle were in a worse condition. The firms filing for Chapter 11 after LaSalle also had a significant higher Bookleverage, which indicates that the proportion debt to assets was higher. The market value of the equity (MVEQ) is presented to examine whether the sizes of the firms differed between the two sample periods. The results in Table 4 show that the MVEQ was higher at the end of the fiscal year prior to the filing for the sample that filed after LaSalle, however this difference was not significant.

[Insert Table 2]

Multivariate analysis

The goal of the multivariate analysis was to quantify the effect of the “market test” and it was conducted by means of four regressions. The results of these regressions are presented in the Appendix Table 3. The first regression analysis only controls for the following variables: Zscore, Bookleverage and HML, SMB and UMD. In addition to these factors the second regression also controls for time effects. The third regression controls for industry effects and the fourth regression controls for time and the industry effect.

[Insert Table 3]

First the results with respect to the main variable of interest MarketTest are discussed. In regression 1 a significant, at an alpha of five percent, coefficient of -0.1 was found for the MarketTest variable. This means that companies that filed after LaSalle compared to the ones who filed before LaSalle had, on average, a 10% lower CAR in the month prior to the Chapter 11 filing. In short, regression 1 indicates that the market reacted stronger in the period after the judgement in LaSalle.

The coefficient on MarketTest remained negative in regression 2, 3, and 4. But, in regression 2, controlled for time fixed effect, and in regression 4, controlled for industry and time fixed effect, the coefficients on MarketTest were not statistically significant. Thus, controlling for time fixed effects impacts the statistical significance of the coefficient on MarketTest, because regression 3, where only industry effects control variables were added, shows that the coefficient on MarketTest was equal to -0.097 (-9.7%) and still significant at an alpha of five percent.

These results could be interpreted in multiple ways. First of all, it could mean that the judgement in LaSalle had no effect on share price reactions. This implies that the foresight of a “market test” does not cause investors to react stronger to a Chapter 11 bankruptcy filing. A second interpretation, which contradicts the first interpretation, is that the “market test” did influence share price reactions, but that the inclusion of the fixed effects with respect to time in the model was incorrect. McKinnish (2000) found that fixed effect models on panel data possibly underestimate the effect of the variable of interest. Finally, the lack of significance could be caused due to the asset price channel possibly not reflecting the effects of the imposed “market test”. Bharath et al (2013) argued that the frequency of “absolute priority deviations” (APD) reduced drastically, and as a result, they found it unlikely that the expectation of APD was reflected in asset prices.

The last interpretation seems to be the most likely and could be an explanation for the fact that the regression models, presented in the Appendix Table 3, have relative low explanatory power (low R-square).

The control variables were also analysed. A significant negative coefficient for Zscore was found in all of the four regressions. This finding was supported by Rose-Green and Dawkins (2002) who also found a significant negative Zscore. A negative coefficient for the Z-score was unexpected as it implies that firms who had a better financial position, and therefore a higher Z-score, experienced a larger price decline. A negative coefficient on Zscore might hint that investors were more surprised of the bankruptcy filings from companies with a better Z-score. The coefficient from the natural log of the MVEQ variable was negative, but the coefficients were only significant in regression 1 and 2. The other control variables were not significant and therefore have no extra explanatory value.

CONCLUSION

This research investigated the impact of the judgement in LaSalle on share price reactions. The hypothesis of this

study was that the “market test” caused self-selection, which meant that the companies who filed for Chapter 11 estimated their chance of emerging high. Thus, the returns for companies who filed after LaSalle were expected to be higher, but still negative, compared to those who filed before LaSalle.

To test the hypothesis an univariate and multivariate analysis was conducted. In the univariate analysis the CAARs and the sample characteristics were compared for the period before and after the judgement. The univariate analysis showed results contradicting the hypothesis. The CAAR was lower after the LaSalle case. A possible explanation for this result was that firms tried to avoid bankruptcy, but still ended up in Chapter 11. The descriptive analyses confirmed that the firms who filed after LaSalle were in a poorer financial condition. Also, the size of the firms was not significantly different before and after LaSalle.

The multivariate analysis showed a negative effect of “market test” equal to 9.7%, when controlled for industry effect. However, when controlling for fixed effects, with respect to time, the effect of the “market test” was not significant. This could be interpreted in several ways. But, the most likely explanation is suggested by Bharath et al (2013) who argued that the asset prices are unlikely to reflect the expectation of the “absolute priority deviation”, because the frequency of these events have rapidly declined. Thus, future research on the effect of “absolute priority deviations” should focus on other more direct channels rather than asset pricing.

ROLE OF THE STUDENT

This paper is written by Kirsten D. Schreuder who declares to take full responsibility for the contents of this document. The Faculty of Economics and Business of the UvA is responsible solely for the supervision of completion of the work, not for the contents. The topic was determined in consultation with her supervisor Dr. R. Perez Ribas.

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APPENDIX

Table 1

Trading	Before LaSalle		After LaSalle		Mean	t-test	Wilcoxon
Day	CAAR(n=9 6)	t-value	CAAR(n=223)	t-value	Difference	t-value	z-value
[-20, 0]	-0.221	-23.860**	-0.306	-37.617**	0.085	6.097**	5.127**

Notes:
** Significant at $\alpha \leq 0.01$ (two-tailed test).
CAAR = cumulative average market-adjusted abnormal return (fractions).

Table 2

	Total Sample	Before LaSalle	After LaSalle	Mean	t-test	Wilcoxon
	mean	Mean	Mean	Difference	t-value	z-value
Zscore	-0.133	0.312	-0.321	0.632	8.329**	11.433**
Bookleverage	0.460	0.411	0.480	-0.0698	-6.420**	-5.794**
MVEQ	126.928	88.365	143.202	-54.836	-0.827	0.018

Note: ** Significant at $\alpha \leq 0.01$ (two-tailed test).

Table 3

	(1)	(2)	(3)	(4)
Intercept	-0.157** (0.042)	-.233** (0.095)	-0.098 (0.080)	-0.016 (0.132)
MarketTest	-0.100* (0.040)	-.008 (0.121)	-0.097* (0.040)	-0.016 (0.114)
Zscore	-0.021** (0.005)	-0.020** (0.006)	-0.023** (0.006)	-0.024** (0.006)
Bookleverage	-0.004 (0.052)	0.017 (0.058)	-0.007 (0.052)	0.018 (0.056)
LN(MVEQ)	-0.018* (0.009)	-0.018* (0.009)	-0.016 (0.009)	-0.016 (0.009)
SMB	0.929 (1.161)	0.232 (1.195)	0.771 (1.170)	0.172 (1.189)
HML	-0.853 (0.975)	-0.289 (0.951)	-0.626 (0.900)	-0.165 (0.891)
UMD	-0.562 (0.833)	-0.217 (0.845)	-0.367 (0.824)	-0.070 (0.836)
Industry (SIC):	No	No	Yes	Yes
Year Fixed Effects	No	Yes	No	Yes
Model R ²	0.0263	0.064	0.036	0.071
Model F	3.470**	2.400*	2.720**	1.900*

Notes:
* Significant at $\alpha = 0.05$ (two-tailed test).
** Significant at $\alpha = 0.01$ (two-tailed test).
In the parentheses the robust standard errors adjusted for clusters are presented.