

December 18, 2012

Secured Credit Externalities

Barry E. Adler (NYU) & Vedran Capkun (HEC Paris)

I. THEORY

Critics of secured credit, e.g., LoPucki (Death of Liability, 1996), argue that financially vulnerable firms will use such credit inefficiently in order to impose on unsecured creditors, and thus to externalize (at least in an ex post sense), the risk of failure. Others, e.g., Listokin (Is Secured Debt Used to Redistribute the Value from Tort Claims in Bankruptcy?: An Empirical Analysis, 2008), argue to the contrary that, in part to avoid creditor control, financially distressed firms will refrain from the use of secured credit where such use would be inefficient. The former argument stems from the observation in finance theory that secured credit is the most effective way for a firm to extend equity's option on a debtor's assets. The latter argument rests on a belief that the costs of secured credit restrains a firm's tendency to use secured credit in this way.

II. EXISTING EVIDENCE

Anecdotal evidence from the recent shift in bankruptcy practice provides that, consistent with the malign explanation of secured credit, firms increasingly employ such credit as financial distress intensifies, an account supported, albeit indirectly, by Adler, Capkun, and Weiss (Value Destruction in the New Era of Chapter 11, 2012). By contrast, Listokin finds that secured debt is used less by firms in industries where tort liability is most likely and where, therefore, critics of secured credit should predict greater use (because tort victims cannot adjust to or covenant against another creditor's priority). We attempt to resolve the inconsistency in the data.

III. OUR DATA

We directly test the change in secured debt use as firms approach bankruptcy. We look at publicly traded firms that filed for bankruptcy between 1993 and 2012. We find a significant run-up of secured credit, as a proportion of assets and of liabilities, prior to bankruptcy filing, this even controlling for similar firms that do not file for bankruptcy in our sample period. That is, more than at other times in their life cycles, firms increase the use of secured credit when bankruptcy becomes imminent, suggesting precisely the causation that the critics claim.

IV. INTERPRETATION AND CONCLUSION

Consistent with the critical account of secured credit, in general, firms issue secured debt as a means to extend equity's option and, in the process, externalize risk. We are skeptical that there exists a tort-exceptionalism as might be suggested by Listokin, and instead speculate that Listokin's results, based on a small sample, are driven by, among other factors, a tendency of firms burdened by tort liability to employ off-balance-sheet finance techniques such as the segregation of assets into off-book subsidiaries.

[Full draft forthcoming prior to NYU/Penn Law & Finance Conference]