Northern Illinois University

Changes in Corporate Governance Structures Preceding and Following Chapter 11 Bankruptcy

A Thesis Submitted to the

University Honors Program

In Partial Fulfillment of the

Requirements of the Baccalaureate Degree

With University Honors

Department of Finance

Kristine Tiedt

DeKalb, Illinois

May 11, 2002

Honors Thesis Abstract
Thesis Submission Form

Author: Kristine Tiedt

Thesis Title: Changes in Corporate Governance Structures Preceding and Following Chapter 11 Bankruptcy

Advisor: Robert Miller **Advisor's Department:** Finance

Discipline: Finance **Year:** 2002

Page Length: 22 **Bibliography:** Yes **Illustrated:** No

Published: No

Copies Available: Hard Copy, Diskette

Abstract:

The purpose of this study is to examine changes in corporate governance structures around the filing of Chapter 11 bankruptcy protection. Information was gathered for companies contained in the sample of the twenty largest Chapter 11 bankruptcies for the years 1995-1997.

Data was collected for each company three years prior to filing, the year the company filed and three years post filing. The board of directors was classified into inside directors, gray directors and outside directors. Ownership was studied with regard to total board ownership in the company and the percentage each member held in comparison with other members. The members serving on the auditing committee and compensation committee were also recorded, as well as total committee size.

Once the data was collected, the Wilcoxon Test and the matched pair test were used to detect significance. These tests both yielded a significant change for the following: a decrease in size of the audit committee, a decrease in the number of gray directors, a decrease in total board size, and an increase in the percentage of ownership per outside director. These restructuring changes support studies showing that certain characteristics of boards may prove to be more beneficial for a firm.

Changes in Corporate Governance Structures Preceding and Following Chapter 11 Bankruptcy

Introduction

The role of corporate governance has become a major issue in recent years. This is partially attributed to current events such as the collapse of Enron. The effects of corporate governance can have a serious impact on the global economy. Ira M. Millstein, senior partner at Weil, Gotshal & Manges LLP, shared his comments in an interview with *Business Week* (Garten 2002), "Good corporate governance protects shareholders' interests and therefore leads to more investment from the United States and elsewhere into developing countries." The article further expanded on Millstein's quote, "From Brussels to Beijing, there is growing awareness that problems relating to auditing, transparency, and boards of directors need serious attention. It's an important moment. Regulators and CEO's should take advantage of it." The article discussed the importance of future legislation as well, "The SEC should establish national standards relating to the qualifications and responsibilities of boards of directors by refining the definition of what constitutes an independent director and specifying the duties of the audit and compensation committees."

The purpose of this study is to examine changes in board composition, the auditing committee, the compensation committee, and equity ownerships of board members around the filing of Chapter 11 bankruptcy protection. Information was gathered for companies contained in the sample of the twenty largest Chapter 11 bankruptcies for the years 1995, 1996 and 1997. The beginning sample of sixty companies was narrowed down to eleven due to the to file for Chapter 11. There are minor exclusions to this rule including insurance and banking institutions, stockbrokers and commodity brokers.

The filing of Chapter 11 may be voluntarily or involuntarily. A voluntary filing initiated by the debtor begins by filing with the bankruptcy court and constitutes the entry of an "order for relief." For an individual or sole proprietorship, no evidence of authorization to file is necessary other than the declaration of an affidavit that is attached to the petition. In a partnership, all general partners must agree to the petition and may be filed on behalf of the partnership by one or more of the general partners. If all general partners do not agree to the petition, the filing is treated as involuntary. Evidence of a declaration by the board of directors authorizing the filing of a petition is generally filed with the petition for a corporation, although it is not always required.

Unlike a voluntary petition, an involuntary petition does not constitute an order for relief. The debtor is given time to challenge the petition. An "involuntary gap" period takes place where the debtor continues to operate its business and may sell off property unless otherwise ordered by the court. An involuntary petition may be filed against any entity that is eligible for a voluntary Chapter 11 petition, excluding a farmer, family farmer or not-for-profit corporation. For an involuntary petition to take place, there must be at least three petitioning creditors when there are twelve or more holders of claims against the debtor. On the other hand, there only needs to be one petitioning creditor if there are fewer than twelve holders of claims against the debtor. The petitioner must have secured claims of at least $5,000, and declare that the

Certain circumstances require the appointment of a trustee. If these circumstances do not exist, the management of the debtor retains control, and is expected to continue normal business activities. The current management team, termed debtor-in-possession, is left in place since they are the most familiar with business activities, therefore maximizing potential for a successful reorganization. The debtor in possession has the following rights: operate its business, receive the benefits of the automatic stay, enter into transactions including the sale or lease of its property, obtain unsecured credit and incur unsecured debt, begin or prosecute actions to recover property or avoid liens on property, and receive the benefits of the extension of time of various periods of limitation.

If the appointment of a trustee would be in the best interests of creditors, current management may be ousted. A trustee is appointed after notice and a hearing if fraud, dishonesty, incompetence, or gross mismanagement of the business is or has been displayed by current management. The only other case that requires the appointment of a trustee is if such an appointment is in the interests of creditors, any equity security holders, and other interests of the estate. The United States trustee selects a trustee after the court orders the appointment. There has been a more recent trend towards the appointment of a trustee due to lack of confidence by creditors in the current management.

Under state law, shareholders possess the right to an annual meeting where the election of directors takes place. However, provisions of the Bankruptcy Code dealing with management of the debtor-in-possession do not bankruptcy process, firms will reduce the size of their board of directors in order to increase effectiveness.

Another study done by Brickley, Coles and Terry (1994), examined the presence of outsiders on the board of directors. The results were consistent with the idea that outside directors better serve the interests of shareholders. This can be partially attributed to reputation concerns and fear of lawsuits by shareholders. Considering the bankruptcy process can cause several problems between management and shareholders, one can conclude that the presence of outsiders on the board of directors will most likely increase prior to and following filing Chapter 11. However, if there is an increase in the percentage of outsiders, there must be a drop in either gray directors or insiders to compensate for the difference. The entire make-up of the board preceding and following filing will be studied for this reason.

A recent article appearing in *CFO* magazine discussed the implications of the accounting problems facing Enron. One of the difficulties foreseen is convincing qualified executives to accept audit committee nominations, says Bob Williamson, CFO of investment bank vFinance Inc., and a former audit committee member and CFO of Equinox Systems Inc. For these reasons, predictions regarding the size of the audit committee during bankruptcy proceedings show a decrease in size. Information on the compensation committee will also be collected in order to see if this prediction holds true for committees in general, or if the information is specific to the audit committee.

representatives, independent investors, or other independent directors. The number of shares outstanding will be collected in order to determine ownership in the company for each board member. Ownership is studied with regard to total board ownership in the company and the percentage each member held in comparison with other members to determine control of the board. The members serving on the auditing committee and compensation committee will also be recorded, as well as total committee size.

Once the data is collected, both parametric and non-parametric tests will be used to test for significance. The Wilcoxon Test will be used as the non-parametric test. This requires the data to be ranked according to the absolute value of the magnitude between the data pairs. Once the ranks are calculated, each rank assumes a sign (+ or -) depending on the original magnitude difference. By using this procedure, more weight is given to a pair showing a large difference than a small difference. The sum of the positive and negative ranks are calculated to find T, which is equal to the absolute value of the lesser value between T+ and T-. T is then compared to the critical value for the sample size to see if significance exists, or if the data is merely due to chance.

A matched paired test is used to test for differences between the means. The standard deviation of the differences is calculated and divided by the square root of the sample size. The average of the differences is then divided by the standard deviation of the average differences to find a T value, which is compared with the critical value to test for significance.

outsiders on the board, parametric tests showed marginal significance for an increase in percentage. This partially supports our hypothesis based on the study done by Brickley, Coles and Terrry (1994) that outside directors are more independent monitors. In summary, the percentage of gray directors serving on the board decreases after bankruptcy, while the percentage of outsiders on the board of directors increases after bankruptcy. One possible explanation is that it is hard to remove insiders, considering the power they possess over the board. Often, the chairman of the board is also the chief executive officer. In fact, in November of 2001, of the 30 companies listed on the Dow Jones, 23 companies had a CEO who was also serving as Chairman of the Board. However, during the bankruptcy process, investors prefer outside leadership since it was the current management that brought the company into bankruptcy in the first place. Also, as discussed previously, outsiders serve in the interests of shareholders. Therefore, the shareholders replace gray directors with outside directors.

Although the percentage of insiders on the board is relatively stable, the percentage of ownership by insider directors decreases by almost 20%. The percentage of gray ownership is almost exactly equal for the years t = -3 and t = 3, even though there is a decrease in the number of gray directors serving on the board. The decline in ownership by the insiders is made up for by the 20% increase in ownership by outsiders for the six-year period. Although it may seem as if insiders are selling off part of their stake in the company, this is not the case considering the 41% of ownership per inside director stays the same. Therefore, the board size must increase or decrease in size to make up for this change.

direction the company is headed. These members are not replaced until the following annual meeting and may never be replaced.

By studying the board of directors as a whole, the data shows that board size significantly decreases. The data is consistent with the Yermack (1996) study conducted on board size discussed previously. On average, the board size decreases from 9.36 at t = -3 to 6.73 at t = 3. Board size decreases in seven out of the eleven companies analyzed throughout the bankruptcy process. Lomas Financial, for instance, had a board size of seventeen prior to filing Chapter 11, yet the board had shrunk to five members three years following the filing. The hypothesis that smaller boards are more effective has consistently been supported, which explains why board size may decrease throughout the bankruptcy process. Board composition can be further broken down into insiders, outsiders and gray directors. Statistical tests did not yield a significant change for the number of insiders or outsiders serving on the board. However, parametric and non-parametric tests yielded a significant decrease in the number of gray directors. As discussed previously, this may be attributed to the disposal of gray directors by inside directors. By engaging in this process, there is more room for outsiders, which would send a positive signal to shareholders.

Conclusion

This paper documents changes in corporate governance including board structure, ownership and committee structure before and after bankruptcy. I report statistically significant changes in the size of the audit committee, number of gray directors serving on the board, total board size, and percentage of

References

Betker, Brian L., Stephen P. Ferris & Robert M. Lawless, 1999, "Warm with Sunny Skies': Disclosure Statement Forecasts," *American Bankruptcy Law Journal*, 809-834.

Brach, Ben, "Streamlining the Bankruptcy Process," *Financial Management*, Volume 27.

Brickley, James A., Jeffrey L. Coles & Rory L. Terry, 1993, "Outside Directors and the Adoption of Poison Pills," *Journal of Financial Economics* 35, 371-390.

Carcello, Joseph V. & Terry L. Neal, 2000, "Audit Committee Composition and Auditor Reporting," *The Accounting Review*, 453-467.

Cook, J. Michael, 1993, "The CEO and the Audit Committee," *Chief Executive*, 44-47.

Daily, Catherine M., 1995, "The relationship between board composition and leadership structure and bankruptcy reorganization outcomes," *Journal of Management*, 1041-1056.

Daily, Catherine M. & Dan R. Dalton, 1994, "Bankruptcy and corporate governance: The impact of board composition and structure," *Academy of Management Journal*, 1603-1617.

Daum, Julie H. & Bettina M. Whyte, 2001, "Delicate state: Board selection in bankruptcy,"*Directors & Boards*, 54-57.

Dobbs, C. Edward, 1980, <u>Reorganizations Under Chapter 11 of the Bankruptcy Code</u>, The Harris Company, Norcross, Georgia.

Garten, Jeffrey E., 2002, "Corporate Standards; Raise the Bar Around the World," *Business Week*, 26.

Gilson, Stuart C., 1999, "Bankruptcy, boards, banks, and blockholders," *Journal of Financial Economics*, 355-387.

Goodman, Amy L., 2001, "Survey of Audit Committee Charters and Audit Committee Reports in 2001 Proxy Statements," *Insights; The Corporate and Securities Law Advisor* 15, 13-18.

Kroszner, Randall S. & Philip E. Strahan, 1999, "Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability," *NBER Working Paper No. W7319*.

Table 1
Statistical Summary of Results

The sample includes companies that were listed in the twenty largest Chapter 11 bankruptcies for the years 1995, 1996 and 1997 and filed proxy statements for the time periods t = -3, t t = 0 and t = 3. Standard deviations for each category are shown in parentheses.

Panel A: Board Structure	**Mean**		**Median**	
	-3	**3**	**-3**	**3**
% Insiders	24.37	25.56	25.00	22.22
	(9.33)	(11.47)		
% Gray	36.63	24.28	33.33	28.57
	(19.73)	(18.21)		
% Outsiders	39.00	50.26	40.00	50.00
	(20.92)	(24.55)		
# Insiders	2.18	1.73	2.00	1.00
	(0.87)	(0.90)		
# Gray	3.36	1.55	2.00	2.00
	(2.34)	(1.29)		
# Outsiders	3.82	3.45	2.00	3.00
	(3.22)	(2.21)		
Total Board Size	9.36	6.73	10.00	7.00
	(3.59)	(1.95)		

Panel B: Ownership	**Mean**		**Median**	
	-3	**3**	**-3**	**3**
% Inside Ownership	78.83	59.31	84.24	55.46
	(27.92)	(32.22)		
% Gray Ownership	15.34	15.42	3.90	1.56
	(28.70)	(27.10)		
% Outside Ownership	5.82	25.27	2.73	13.56
	(6.87)	(31.18)		
% Inside Ownership/Director	41.99	40.09	32.03	33.14
	(29.93)	(25.88)		
% Gray Ownership/Director	3.87	7.49	0.89	0.39
	(5.21)	(13.61)		
% Outside Ownership/Director	1.38	6.40	0.91	1.92
	(1.89)	(7.84)		
% Shares Owned by Board	11.23	18.72	4.85	16.48
	(18.16)	(18.09)		
% Shares: Officers & Directors	13.70	21.19	7.32	16.44
	(18.49)	(19.04)		

Panel C: Committees	**Mean**		**Median**	
	-3	**3**	**-3**	**3**
# Audit Committee	3.73	3.18	3.00	3.00
	(0.90)	(0.87)		
# Compensation Committee	3.18	2.73	3.00	3.00
	(1.33)	(1.42)		