Debt Renegotiation
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Junk bond woes suggest it is time to reform the corporate tax code and to rethink private debt relationships.

Debt Renegotiation

BY R. GLENN HUBBARD

Is corporate leverage excessive? A "financially fragile" situation exists when firms' debt burdens constrain investment, employment or production. Yet, if high leverage is so dangerous, why were debt levels selected voluntarily by the private economy? Is the current corporate financial situation simply the outcome of an efficient market?

There are cases for and against high leverage. While provision of proper incentives to managers may in part underlie the trend toward debt, high leverage is, in practice, a very blunt way to address the incentive problem and also one that opens up the possibility for undue exposure to the risks of financial distress.

The trend to high leverage is relatively new. Over the entire postwar period, equity finance was dominant — until the 1980s, when financing patterns changed course. While corporations continue to rely heavily on retained earnings, they have sharply adjusted the composition of external finance. Most notably, there have been substantial equity repurchases, financed primarily with debt. Leverage ratios have risen mainly as the product of corporate capital restructuring. Net new equity issues totaled (-)$131 billion in 1988, as compared to (+)$25 billion five years earlier.

The Shift to Debt

An important effect of this shift to debt has been a substantial rise in debt-service burdens and an associated rise in bankruptcies and defaults.

A significant factor underlying the shift to debt has been a dramatic rise in corporate restructuring. Prompting the restructuring have been waves of mergers, acquisitions, leveraged buyouts and defenses against LBOs. Goldman, Sachs & Co. has estimated that the equity base of U.S. corporations shrank by about $420 billion between 1982 and 1988, and that debt supplanted about three fourths of this reduction.

Another important change in corporate financial policy involved the kind of debt being issued. Private debt issues have declined in relative importance; the trend has been toward public issues, particularly non-investment-grade bonds.

Those who are sanguine about the rise in leverage typically maintain that debt is desirable because it empowers lenders with an indirect means to monitor the activities of managers. The need for some kind of supervision owes to the separation between ownership and management that is characteristic of the traditional corporate structure.

Advocates of increased leverage interpret the recent wave of LBOs in this light. The restructuring improved managerial incentives both by converting claims of lenders from equity to debt and by concentrating ownership in the hands of management. By promising lenders a fixed stream of payments, debt effectively ties managerial rewards more closely to the performance of the firm.

However, high leverage is a very blunt way to align managerial incentives. It works best when most of the variation in cash flow depends on the efforts of the managers. It works poorly when most of the variation is beyond the control of the firm's managers — to the extent that debt is costly to renegotiate.

Instead, financial arrangements should link payments to creditors to industry- and economy-wide performance, as would the standard use of both debt and equity. Standard debt contracts do not provide the flexibility needed for sharing of common risks. The advocates of high leverage argue, however, that most debt is easily renegotiable in practice and is therefore implicitly like equity. Whether they are right about renegotiation is probably the pivotal question.

One cause of concern over high leverage rests on the

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premise that it limits the ability of corporations to share cyclical risks with outside lenders as equity would. Ideally, corporations would like to issue "debt" securities with variable principal. In this way, they could collect the tax benefits from debt finance without sacrificing any flexibility in adjusting to common disturbances.

More generally, if allowed the option, firms would like to relabel equity as debt for tax purposes. The spirit of the tax code precludes this kind of activity. The IRS has generally required that any instrument called debt for tax reasons must have a payoff that is "sum certain." Moreover, there are institutional restrictions on placing explicit recontracting provisions in debt contracts. Accordingly, there is reason to suspect that the current tax system encourages corporations to adopt a financial structure more exposed to cyclical risks than would be the case in the absence of any subsidy to debt.

> "The tax system encourages the firm to risk the possibility of having a 'debt overhang' problem in a recession."

The problem is this: Corporate managers and directors may not manage assets in the interest of the firm's shareholders; leveraged financial structures are partially designed to address that incentive problem. However, the tax system introduces a trade-off between insulating the firm against business-cycle risk and minimizing tax burdens. Incentive considerations suggest that if all liabilities were treated symmetrically by the tax code, financial arrangements would be a mixture of debt and equity. Effectively, equity serves as a buffer to business-cycle risk; firms may reduce dividend payments in recessions.

Under a tax system that treats debt favorably, firms are induced to issue a small fraction of equity and to absorb more business-cycle risk than they would otherwise choose. Indeed, if the probability of a recession is sufficiently low, it may be in a firm's interest to obtain the tax advantage of a high debt-equity ratio at the risk of having a quantity of debt that makes it necessary to cut back operations in the event of a general business downturn. The tax system thus encourages the firm to risk the possibility of having a "debt overhang" problem in a recession.

The question of renegotiation is critical here. Having renegotiable debt makes debt effectively like equity and thus unravels the effect of the tax bias. There would be no effects on firms' real decisions about production, employment or investment, for example.

Recent claims about the easy renegotiability of corporate debt during financial distress — that it is "equity in drag" — are probably overstated for a number of reasons. First, holdings of junk bonds are quite diffuse relative to traditional patterns, making coordinated renegotiation costly and unlikely. It is also no longer true that high-yield debt avoids the restrictions common in traditional private placements. A recent First Boston Co. study concluded that the market appears to be coming full circle, back toward the stringent incentive packages of the private placement market.

In addition, "exchange offers" of securities — the typical mechanism for out-of-bankruptcy renegotiation — are problematic with multiple credit interests. Moreover, completed exchange offers historically have failed to provide sufficient breathing room for distressed companies to rebound.

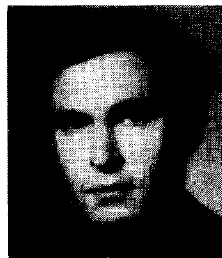
What about "payment in kind" obligations that allow the issuer to pay interest in cash or in additional securities? Like equity, these instruments permit firms to overcome temporary liquidity problems. However, unlike equity, while they permit deferral of interest, they do not allow for costless adjustment of the principal obligation. They do not insulate corporations from systemic risks.

Don't private market makers have an incentive (say, for reputational reasons) to guarantee liquidity in the junk bond markets? It is true that Drexel Burnham Lambert played an important role by providing liquidity in the secondary market. Private firms can perform a "lender of last resort" function when defaults or near-defaults are isolated incidents. However, they lack the resources to intervene in the midst of a wave of defaults, as Drexel's failure has made very clear.

Policy Choices

We are left with some clear and difficult policy choices. An important problem with the current system of corporate taxation is that it seeks to classify particular forms of financial contracts for tax purposes and thereby interferes with efficient choices of leverage. A number of tax reforms are possible. The guiding principle should be to let the private market design finance contracts to address incentive problems in corporate governance — without distorting contract design for the purpose of obtaining a tax subsidy.

Recent problems in public debt markets also suggest renewed roles for private debt relationships. Toward this end, another avenue for serious consideration is relaxing restrictions on provisions for renegotiation during financial distress. Such actions would involve removing restrictions on recontracting in many debt contracts, and, importantly, give to commercial banks and institutional investors the right to participate more closely in the activities of the firms in which they invest.



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