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Distressed assets Merger and Acquisitions and Insolvency and Bankruptcy code nexus

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There have been several bankruptcies since the start of the global financial crisis in 2008, including fire sales and forced purchases. Organizations that were facing significant financial difficulties fought to restructure and work out their debts, and some even declared bankruptcy. Many of the parties involved may find acquisitions of these struggling enterprises to be a more favourable exit path (1990; Hambrick and D'Aveni, 1988; Balcaen and colleagues, 2009¹). A look at the dangers of buying such bankrupt companies is presented in this article. To date, there has been little study on distressed purchases, which has primarily focused on performance. Although previous research suggests that distressed acquisitions result in favourable anomalous stock returns for acquirers, the findings for operational success are varied (Clark and Ofek, 1994²; Hotchkiss and Mooradian, 1998³; Carapeto et al., 2009)⁴. Nevertheless, while assessing the effectiveness of an acquisition, the effect on risk

¹ Michael C. Jensen, 'Corporate control and the policies of finance' (1991) 4 (2) Journal of Applied Corporate Finance, 1333

² Kent Clark & Eli Ofek, 'Mergers as a means of restructuring distressed firms: an empirical investigation' (1994) 29 (4) Journal of Financial and Quantitative Analysis, 541-565

³ Edith S. Hotchkiss & Robert M. Mooradian, 'Acquisitions as a means of restructuring firms in Chapter 11' (1998) 7 (3) Journal of Financial Intermediation, 240-262

⁴ Maria Carapeto, Scott Moeller & Anna Faelten, 'The good, the bad, and the ugly: A survival guide to M&A in distressed times' (Research Gate, 2009) <https://www.researchgate.net/profile/Scott-Moeller-2/publication/266568777_The_good_the_bad_and_the_ugly_A_survival_guide_to_MA_in_distressed_times/links/54b9338d0cf24e50e93c2e47/The-good-the-bad-and-the-ugly-A-survival-guide-to-M-A-in-distressed-times.pdf> accessed 17 January 2022

should also be taken into account in spite of the credit crisis raising risk awareness, studies on the risks associated with corporate M&A transactions remain rare. Furthermore, there is no study on the risk implications of distressed purchases.

Keywords: *corporate mergers and acquisition, bankruptcy code, insolvency, economies.*

INTRODUCTION

Previous studies appear to demonstrate that the average risk of the acquirer increases following an acquisition. However, few studies have looked into the factors that influence acquirer risk. Risk minimization is one of the most frequently cited motivations for mergers. Conglomerate mergers, according to Amihud and Lev (1981)⁵, reduce risk by diversifying the combined entity. However, further research suggests that changes in financial leverage increase the chance of acquirer default.⁶ As a result, it is important to know why a merger or acquisition can alter the risk of the buyer. Because acquirers are exposed to additional risks in distressed M&A transactions, this type of deal offers a unique setting for examining M&A transaction risk. Distressed acquisitions may present appealing chances to expand geographically or by activity, gain market share, and create new revenue at a lower cost. Simultaneously, because these transactions frequently take place in shorter periods and include more sophisticated appraisals, there is a greater danger of overpayment. Furthermore, executives may misjudge the time and effort required to turn around and incorporate a failing company. Because of this, the capacity to assess and manage risk will decide the company's overall risk exposure and return to shareholders.

Most previous research on ill-fated mergers and acquisitions concentrated on their effects on financial results. Clark and Ofek are partners in crime (1994)⁷ study 38 distressed takeovers in the United States using a variety of performance metrics and come to the conclusion that the acquirers had a poor post-merger performance. It was found by Hotchkiss and Mooradian

⁵ Yekov Amihud & Baruch Lev, 'Risk reduction as managerial motive for conglomerate mergers' (1981) 12 (2) Bell Journal of Economics, 823-837

⁶ Alope Ghosh & Prem C. Jain, 'Financial leverage changes associated with corporate mergers' (2000) 6 (4) Journal of Corporate Finance, 377-402; Erwan Morellac & Alexei Zhdanov, 'Financing and takeovers' (2008) 87 (3) Journal of Financial Economics, 556-581

⁷ Kent Clark & Eli Ofek (n 2)

(1998), who studied a sample of 55 US acquisitions, following the purchase of a target, acquirers enhance their operating results and produce positive abnormal returns. Carapeto et al. (2009)⁸ report that when taking over a distressed or insolvent target, acquirers experience favourable anomalous announcement returns. Furthermore, when compared to the combination pre-b, the combined long-term performance improves.

In a conclusion, prior research shows that problematic acquisitions result in favorable anomalous stock returns for the acquirers, but the implications on operational performance are unclear. While looking at the variables that impact acquirer risk, we expand on previous research on problematic M&A. The first step is the non-distressed M&A literature since there are not many studies on this topic. Only a few research papers have looked at the elements that determine whether or not risk shifts occur after an acquisition. Furthermore, previous research has used a variety of methodological approaches.

ANALYSING THE RISK

Calculating the volatility of stock returns is one of the first and most often used methodologies for analysing risk in the context of corporate acquisitions, Langetieg et al. (1980)⁹ Show that mergers enhance total, systematic, and distinctive risk by collecting data on 82 US mergers. Lubatkin and O'Neill studied 297 large mergers in the United States (1987)¹⁰ identified a link between mergers and an increase in idiosyncratic danger. They also discover a considerable reduction in the systematic and overall risk associated with connected mergers. This method has recently been used by Amihud et al. (2002) and Mishra et al. (2005)¹¹ so that bank mergers' potential risks may be evaluated and there was no significant benefit found by Amihud and colleagues (2002).

Mishra et al. (2005) observed that “for non-conglomerate bank mergers, total and idiosyncratic risk reduced substantially, whereas systematic risk stayed the same. By calculating the implied

⁸ Maria Carapeto, Scott Moeller & Anna Faelten (n 4)

⁹ Terence C. Langetieg, Robert A. Haugen & Dean W, Wichern, 'Merger and stockholder risk' (1980) 15 (3) Journal of Financial and Quantitative Analysis, 689-717

¹⁰ Michael Lubatkin & Hugh M. O'Neill, 'Merger strategies and capital market risk' (1987) 30 (4) Academy of Management Journal, 665-684

¹¹ Suchismita Mishra, Arun Prakash et.al, 'Bank mergers and components of risk: An Evaluation' (2005) 29 (1) Journal of Economics and Finance, 85-96

volatilities of options contracts”, Bharath and Wu (2005) and Geppert and Kamerschen (2008)¹² study the implications of corporate US mergers on acquirer risk. In four years before the merger and one year following the merger announcement, Bharath and Wu (2005)¹³ There has been a significant rise in the implied volatility total, systematic, and individual. This pre-merger build-up may be explained by the idea that M&As are a reaction to industry shocks. For the first 18 months after the merger was completed, Geppert and Kamerschen (2008) analysed a sample of 25 corporate mergers and found that mergers did not decrease risk in the same manner that an individual firm's portfolio did. This indicates that mergers raise the anticipated risk that shareholders face as a result of the transaction.

Recent research has used default risk measures to evaluate risk changes. The rising number of research are generating new improved measures based on Merton's model since the best risk measure in the failure prediction literature is still being contested (1974)¹⁴, There are other ways to calculate default probability, such as using CDS spreads or bond yields (Bharath and Shumway, 2008), options (Capuano, 2008), or even using Moody's KMV. Using EDF in corporate M&A research for the first time, a study by Furfine and Rosen (2011) found that the acquirer default risk increases following mergers because management actions outweigh the risk-reducing benefits of asset diversification. With large option-based compensation, poor previous performance, and significant idiosyncratic equity volatility, acquisitions are extremely hazardous for CEOs.

Vallascas and Hagendorff (2011)¹⁵ a pioneering study utilising Merton's distance to default model analysed the risks associated with bank mergers and acquisition activity. According to their findings, mergers and acquisitions have only a marginal impact on acquirer risk. In cross-border and conglomerate mergers as well as M&A done under poor supervision, low-risk banks suffer a significant rise in default risk, implying that acquirer pre-merger risk is a key

¹² Gero Geppert & David R. Kamerschen, 'The effect of mergers on implied volatility of equity options (2008) 17 (2) International Review of Financial Analysis, 330-344

¹³ Sreedhar T. Bharat & Guojan Wu, 'Long-run volatility and risk around mergers and acquisitions (*Semantic Scholars*, 14 March 2005) <<https://www.semanticscholar.org/paper/Long-Run-Volatility-and-Risk-Around-Mergers-and-Bharath-Wu/e24b2dc63053459f88383e921c2158e99105be5e>> accessed 17 January 2022

¹⁴ Harry M. Markowitz, *Portfolio Selection Efficient Diversification of Investments* (New York, Wiley 1959)

¹⁵ Francesco Vallascas & Jens Hagendorff, 'The impact of European bank mergers on bidder default risk' (2011) 35 (4) *Journal of Banking and Finance*, 902-915

component in acquisition-related risk implications. Finally, it may be stated that acquirer risk increases on average following acquisitions. There is still a lack of information about what is producing these risk shifts, though.

REDUCTION IN RISK

Banks and companies frequently cite the need for risk diversification as one of their primary objectives. According to Craig and dos Santos: M&A. Acquirers (1997)¹⁶, focusing on financial institutions whose geographic and business diversification will allow you to reduce your acquisition risk significantly. Conglomerate mergers, according to Amihud and Lev (1981), reduce risk by diversifying the combined entity. Lewellen (1971)¹⁷ proposes a coinsurance impact based on non-perfectly linked cash flows. When companies merge, they reduce the amount of risk, which lowers their external financing costs, increases their debt capacity, and provides them with a greater tax shelter. Utilizing a diverse portfolio to reduce risk does not appear to be in shareholders' best interests as they can do so on their own. To reduce their own personal risk exposure, CEOs are also looking for conglomerate merger opportunities. Personal wealthier managers want to expand their holdings in a business by pursuing mergers and acquisitions and other forms of diversification (May 1995). In contrast to connected acquisitions, conglomerate mergers may actually raise risk rather than reduce it because of a lack of awareness of the industrial environment. The conclusion is that troubled target acquirers typically work in the same industry, as Clark and Ofek (1994) have found out. Buyers of insolvent companies, as reported by Hotchkiss and Mooradian (1998), from their past relationship with the target, they know the asset's worth and best usage.

Furthermore, because of economies of scale and scope, linked mergers are more synergistic, resulting in lower costs (Chatterjee and Lutbatkin, 1990)¹⁸. As a result, we expect acquirer risk to rise as a result of conglomerate distressed mergers. International growth, a key driver of cross-border M&A, may help reduce risk by spreading it across different markets. Earnings

¹⁶ Ben Craig & João Cabral dos Santos, 'The risk effects of bank acquisitions' (1997) 33 (2) Federal Reserve Bank of Cleveland, *Economic Review*, 25-35

¹⁷ Wilbur G. Lewellen, 'A pure financial rationale for the conglomerate merger' (1971) 26 (2) *Journal of Finance*, 521-537

¹⁸ Sayan Chatterjee & Michael Lubatkin, 'Corporate mergers, shareholder diversification and changes in systematic risk' (1990) 11 (4) *Strategic Management Journal*, 255-268

volatility may be decreased because two geographically diverse markets are imperfectly connected (Seth, 1990). Fatemi (1984)¹⁹ investigated the impact of company foreign diversity and discovered that total and systematic risk decreases for shareholders. Furthermore, internationalisation may improve the possibility of synergies being realised. We believe that expanding internationally through distressed purchases decreases risk because of the quick access to new markets, resources, and technology. A conglomerate and a cross-border dummy are included in our multivariate analysis. Since Senbet and Seward's in-depth research on corporate financial crises and bankruptcy, there have been significant changes (1995). The new poll adds to the previous one's findings and reframes the discussion in light of the most recent changes. To summarise, the review starts with theoretical foundations and then moves on to empirical findings. There are several unanswered questions about business financial difficulty and bankruptcy, and further study is needed.

THE NEXUS

In addition to demonstrating the field's current level of knowledge, the evaluation will stimulate further research. The complete separation of financial and investment choices shows that bankruptcy and the operating success of a firm need not be linked. Neither economic hardship nor poor performance is caused by bankruptcy. When discussing the economic consequences of corporate bankruptcy, it is easy to forget about this essential aspect. Financial distress and economic distress are two closely related but distinct words that are generating some complications. Modigliani and Miller's (1963)²⁰ argument in favour of debt financing versus equity funding because interest expenses may be deducted from taxable profits for business purposes while payments to equity investors cannot be deducted (e.g., dividends are not tax-deductible on the personal account). Because every additional dollar of debt provides a tax deduction as a marginal benefit, the value of the firm is maximised by financing corporate investment choices with as much debt as is practicable in this model. Although Kraus and

¹⁹ Ali M. Fatemi, 'Shareholder benefits from Corporate International Diversification' (1984) 39 (5) *Journal of Finance*, 1325-1344

²⁰ Randall Morck, Andrei Shleifer & Robert Vishny, 'Do managerial objectives drive bad acquisitions?' (1990) 45 (1) *Journal of Finance*, 31-48

Litzenberger are financial economists, some financial economists believe otherwise (1973)²¹, Scott (1976), and Kim (1978)²², propose a reconciliation between observed debt limitations and Modigliani-financial Miller's policy assumptions by accounting for the costs of bankruptcy.

It is easy to see why there is an ideal capital structure with a finite number of investors. Corporations make a trade-off between tax savings from interest deductibility and the projected cost of bankruptcy, which restricts the amount of debt they may take on. Leland (1994)²³ has closed-form answers to the analytical framework to understand that Friedman pioneered the study of the link between the value of corporate debt and the optimal capital structure in his seminal work. As a result of Leland's model, it is possible to study in-depth corporate bond prices and optimal leverage ratios such as company tax rates, bankruptcies costs, firm asset values, firm risk, and risk-free interest rates.

A breach of a positive net-worth covenant can cause bankruptcy, as can equity holders making the wisest option. A company's bond value, bond yield, leverage ratio, and bankruptcy timing are all determined by the trade-off between tax advantages from debt and bankruptcy expenses, according to the author's research. It is also clear that Leland's strategy helps strike a good balance between a company's tax benefits and the costs of its debt. Equity investors are tempted to raise the risk of a firm in financial difficulties or insolvency by "asset substitution," which is the act of substituting one asset with another. A higher-than-average net worth as long as the debt is protected by the covenant, owners cannot profit from rising business risks, covenants in corporate bonds assist to relieve the agency problem. Enterprises more vulnerable to the agency cost of debt may prefer protected debt despite its lower potential tax advantages. According to Haugen and Senbet, the transaction costs of resolving financial distress through financial markets should limit the costs of financial distress or bankruptcy. (1978)²⁴. According to this theory, financially troubled companies have two choices for

²¹ Allen Kraus & Robert H. Litzenberger, 'A state-preference model of optimal financial leverage' (1973) 28 (4) *Journal of Finance*, 911-922

²² E. Han Kim, 'A mean-variance theory of optimal capital structure and corporate debt capacity' (1978) 33 (1) *Journal of Finance*, 45-64

²³ Hayne E. Leland, 'Corporate debt value, bond covenants, and optimal capital structure' (1994) 49 (4) *Journal of Finance*, 1213-1252

²⁴ Robert A. Haugen & Lemma W. Senbet, 'Bankruptcy and agency costs: Their significance to the theory of optimal capital structure' (1988) 23 (1) *Journal of Financial and Quantitative Analysis*, 27-38

addressing their issues: (1) official reorganisation through the courts, or (2) informal reorganisation through the financial markets. As a result, financial distress and bankruptcy must be less expensive than the other two alternatives. There will be two parts after this one where we will discuss theories about the benefits and drawbacks of both private and public schooling.

CONCLUSION

The risk profile of a company and its attitude toward risk may have an impact on its purchase decisions. Furthermore, depending on the initial risk profile, an acquirer's strategic needs may fluctuate. Only high-risk banks benefit from diversity, according to Brewer (1989), however, Vallascas and Hagendorff (2011)²⁵ show that only low-risk institutions increase the chance of default. High-risk acquirers, according to Bruton et al. (1994), may buy firms in order to get out of a poor situation, improve their resources, or boost their competitiveness. As a result, distressed prospects present appealing opportunities due to the strong upside restructuring potential. Furfine and Rosen (2011) also imply that low-risk buyers are more likely to take chances, high-risk buyers are less likely. Pre-acquisition risk is tested in our regression model by using a dummy variable that differentiates between low and high-risk purchasers. The size of the premium, according to Clark and Ofek (1994), is negatively related to the restructuring's performance because of overpaying. If greater synergistic gains are predicted from the purchase, acquirers may pay a bigger acquisition premium. When these synergies cannot be realised, however, overpaying may ensue. Furthermore, management arrogance may result in larger acquisition premia since management is overconfident. In other words, when premiums grow, so does the danger of acquiring a new policy. The takeover premium is subtracted from the target stock price, and the result is multiplied by 100.

In addition, a bogus public dummy variable is used to determine whether or not the expected state is present. That is why a publicly troubled target is less risky than a privately distressed one, according to our calculations. It is also important to consider the target's relative size to the buyer larger goals have a higher probability of reducing risk than smaller goals (Vallascas

²⁵ Francesco Vallascas & Jens Hagendorff (n 15)

and Hagendorff, 2011). Purchases of large targets, in contrast to diversification benefits, are harder to integrate than purchases of smaller targets. To add insult to injury, it is possible that reorganising bigger objectives may be more challenging (Clark and Ofek, 1994). We anticipate a risk increase as a result of major target purchases. We also account for acquirer size, which is determined by the log of asset market value. Larger acquirers should be less harmed by troubled acquisitions because they have less business risk. Market liquidity is accounted for by taking into account the corporate spread, which is computed as the difference between AAA and BAA corporate bonds. Acquisitions made while credit is available to put acquirers at more risk than acquisitions made when credit is restricted. We also incorporate regional dummies to account for bias in the acquirer and target countries. We also look at changes in institutional characteristics among countries that could affect acquirer risk-taking. Consequently, we combine a country's shareholder-and creditor-protection score with an anti-director rights index. (La Porta et al., 1998). Finally, in order to keep track of the acquirer industry.