What Happens When a Corporate Bond Issuer Defaults?

Schwab Center for Financial Research

Key Points:

- A corporate bond default generally occurs when the issuer fails to make timely interest or principal payments.
- After a default, what a bondholder receives, and when they receive it, is unknown in advance.
- An investor may attempt to sell a defaulted bond in the secondary market or hold it through the bankruptcy process, but the proceeds would likely be far less than the bond’s original value.

Investors may wonder what happens if their bond issuer is unable to repay its debts. Unfortunately, the answer isn’t always straightforward. There are, however, several things corporate bond investors should know.

Reasons leading to a default may differ and can affect the restructuring and repayment process. What bondholders receive after the default—and when they receive it—can vary significantly. Recovery proceeds may come in different forms, including as a newly issued bond, cash, stock, or some combination of the three, and the process can take anywhere from a few months to several years. Below we’ll discuss what investors need to know when a corporate bond they own defaults.

The default rate ebbs and flows

Corporate defaults may occur for any number of reasons, but they tend to rise the most during periods of economic stress, and especially during recessions.

As the chart on the next page illustrates, the default rate surged above 10% during the previous three recessions and hit a new ten-year high at the end of 2020 due to the economic impact of the COVID-19 crisis. When we discuss the default rate, keep in mind that it's presented as a percent of the overall “speculative-grade” market, meaning those with sub-investment grade or “high-yield” ratings.
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One factor that tends to lead issuers to default is a surge in borrowing costs. Outside of paying off debts with cash on hand, corporations tend to issue new bonds to refinance maturing bonds. If the cost of borrowing is simply too high, it might make sense for an issuer to default rather than refinance at rates that might significantly impact its cash flows. The chart on the next page compares the default rate with the average “spread” of the Bloomberg Barclays U.S. Corporate High-Yield Bond Index. A rise in defaults tends to follow a rise in spreads. The average spread of the index surged in early 2020, and the default rate followed thereafter.

The basics of a default

What does “default” mean? In its simplest form, it’s when an issuer fails to make a scheduled interest or principal payments on its bonds. According to credit rating agencies like Moody’s and Standard and Poor’s, if a corporation breaks one of its covenants, that can also trigger a default. The rating agencies also consider a “distressed-debt exchange” a default. Individual investors generally don’t have much say in the details of a distressed-debt exchange, as the negotiations generally happen with large institutional investors who likely own a large portion of the debt. In a distressed-debt exchange, the value of the proceeds is generally below the initial par value of a given investment.

For many individual investors, what really matters is when a company files for bankruptcy protection. Issuers under financial stress, such as those facing liquidity or solvency concerns, may consider Chapter 7 or Chapter 11 bankruptcy protection. What investors get after the bankruptcy process can vary considerably.

A company that files Chapter 11 bankruptcy receives protection from creditors and time to restructure its balance sheet. Once the bankruptcy process is completed and the restructuring plans are approved in court, the corporation “emerges” as a newly organized and restructured company. The restructured corporation is usually in better financial shape, usually with less debt than before the bankruptcy proceedings. Depending on the size and complexity of the bankruptcy, this process can take a few months to several years.

Chapter 7 is more of a “last resort” option. Rather than restructuring, a Chapter 7 bankruptcy means the corporation ceases operations and liquidates its assets. As the corporation sells its assets—sometimes at very depressed prices—the proceeds are used to pay off its creditors, which includes bondholders. Like a Chapter 11 bankruptcy, it can take a long time for bondholders to receive any proceeds from a Chapter 7 filing. The order of payment can vary. Corporate bond holders are often below government taxes, bank loans, and other creditors like employees and suppliers. However, they are ahead of preferred and common stockholders.

What happens to holders of corporate bonds that default?

Unfortunately, what happens to bondholders after a default isn’t always easy to answer. As discussed above, bankruptcy processes can take a long time. Bonds of issuers facing financial difficulties will often drop in price as investors become concerned with the issuer’s ability to make timely interest and principal payments. A drop in price doesn’t always lead to a default, however, and prices could rebound.

1A covenant is a legal agreement that defines what the issuer can or cannot do over the life of the bond. For example, a bond covenant might include a restriction on the issuer’s ability to take on additional debt, since a rising amount of debt may make the issuer less creditworthy.

2A distressed debt exchange occurs when an issuer may be facing financial difficulties, which sends its bond prices lower. The issuer may then offer to “tender” the bonds at a price above the price that the bonds trade at in the secondary market, but below the par value. According to the credit rating agencies, this is generally viewed as a default since the issuer has redeemed an obligation at a price below the previously promised price.

Source: Standard and Poor’s Trailing 12-Month Speculative-Grade Corporate Default Rate, December 2020. S&P conducts its default studies on the basis of groupings called static pools. For the purpose of the study, S&P forms static pools by grouping issuers by rating category at the beginning of each year that the CreditPro database covers. Each static pool is followed from that point forward. All companies included in the study are assigned to one or more static pools. When an issuer defaults, S&P assigns that default all the way back to all of the static pools to which the issuer belonged. S&P calculates annual default rates for each static pool, first in units and later as percentages with respect to the number of issuers in each rating category. Shaded bars represent the following recessions as measured by the National Bureau of Economic Research: July 1990 - March 1991, March 2001 - November 2001, December 2007 - June 2009, and February 2020 - December 2020. At the time of this publication, the 2020 recession was ongoing.
When a company does file for Chapter 7 or Chapter 11, what bondholders “recover” can vary significantly. Recovery is what a bondholder ultimately receives from holding a defaulted bond through all court proceedings. Unfortunately, both the ultimate recovery value and how long it will take to receive the recovery value are unknown in advance. Most importantly, the recovery is often less than the $1,000 par value of the bond. In other words, it’s unlikely that an investor would “recover” what the bond was originally worth. The chart below illustrates that what bondholders eventually receive can vary and is often well below the amount that many investors may have initially invested.

It’s not just the value of the proceeds that can vary, but how investors are compensated. It’s usually not as simple as just receiving a cash payment in lieu of the defaulted bonds. Since Chapter 11 results in a newly organized company, holders of the defaulted bonds usually receive some sort of new securities as proceeds. The proceeds may consist of new bonds, an equity stake in the company, equity warrants, or some combination of those options. Conversely, in a Chapter 7 bankruptcy, bondholders often receive cash proceeds as the issuer liquidates its assets. The proceeds may come in installments, as various assets are liquidated, and this can take a very long time.

Key points to be aware of when a corporate bond you own defaults:

- **The time until ultimate recovery is unknown.** Some restructurings are done relatively quickly, while the restructuring process for more complex issuers could take several years.
- **Don’t expect any more income payments.** Bonds are often purchased for the income payments they provide. Since defaulted bonds no longer make coupon payments, investors are stuck holding non-interest bearing investments with an unknown recovery value and unknown recovery date.
- **Credit ratings can be important.** If a bond has been downgraded, its likelihood of default may have risen. Consider the outlook for the issuer and consider selling the bond in the secondary market if the issuer’s financial condition worsens or if the outlook is negative. Note that the market for lower-rated issues is generally less liquid than the market for high quality fixed income investments.
- **The bankruptcy process can be time-consuming and costly.** Investors will likely need to deal with legal paperwork and may need to vote on certain provisions related to the court proceedings. If this may seem too complex and burdensome, investors may want to consider selling their bonds—likely at a lower price—in the secondary market.

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3 An equity warrant gives the warrant owner the right, but not the obligation, to buy an equity security at a certain price before the warrant’s expiration. Warrants tend to have longer expirations dates than equity call options.
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What to do now

Unfortunately, dealing with a defaulted bond isn't very straightforward. But investors do have a couple of options:

1. Continue to hold the defaulted bond through the bankruptcy proceedings. But how much bondholders receive, and when they receive it, is unknown in advance.

2. Sell the bond in the secondary market. You'll get a known amount and won't need to be concerned with the bankruptcy proceedings. Selling a defaulted bond before the restructuring process is over can lead to more or less than what may have been received if the bond was held through the restructuring process, however.

Source: Moody's Investors Services. "Annual default study: Following a sharp rise in 2020, corporate defaults will drop in 2021," January 28, 2021. Ultimate recovery is the value creditors realize at the resolution of the default event and is calculated on a volume weighted basis. For example, for issuers filing for bankruptcy, the ultimate recovery is the present value of the cash and/or securities that the creditors actually receive when the issuer exits bankruptcy, typically 1-2 years following the initial default date. Columns represent the year that recovery occurred, not the year the issuer defaulted.
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