

Non-Technical Summary

Bankruptcy, Debt Structure, and Debt Contracts: Empirical Evidence from the Czech Republic

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The paper deals with the effects of soft and tough bankruptcy laws on investment level, interest rate, expected profit and a debtor's behavior. Soft bankruptcy law is identified with the possibility of the absolute priority rule (APR) violation and the tough bankruptcy law with the strict observance of the APR. Under APR we understand the rule that in bankruptcy, creditors must be paid in full before shareholders can receive some payout. A principal-agent model is developed to analyze the problem.

It is a generally accepted fact in the bankruptcy literature that tough bankruptcy law exacerbates the gambling on resurrection problem. If this were the case, then soft law could produce more socially desirable results than the tough law. The two setups are compared to the first best results that would be achieved by a social planner.

Tough bankruptcy law is taken as a benchmark. Comparison with the first best shows that for projects above a certain profitability threshold, tough bankruptcy law leads to higher interest rate, lower expected profit, and, in some cases, the choice of too risky strategy.

When the degree of softness (the share of the bankrupt firm value the shareholders can keep away from the creditors) in the soft law setup can be set endogenously within the contract, then the soft law performs either the same or better than the tough law. For projects where the debtor would not behave too risky even under tough law, the degree of softness is simply set to zero. For projects where the debtor

would have an incentive to choose too risky strategies under the tough law, the degree of softness is set to such a level that these incentives are mitigated and the debtor is made to behave optimally. In the case of endogenous degree of softness, the investment level, profit and strategy choice are at socially optimal levels. The optimal degrees of softness obtained in simulations, however, are very high compared to those observed in reality.

When the degree of softness is set by the law, instead of being specified in the contract, then the results concerning the optimality of investment, profit level and strategy choice do not generally hold. In particular, when the degree of softness is lower than optimal for a given project, then, contrary to the established opinion, the incentive for risky behavior may be even stronger than under the tough law. In this case, there is a range of projects for which soft law leads to socially worse results than tough law.

Overall, the main findings of the paper can be summarized as follows:

- the desirable properties of the soft law are present only under very high degrees of softness, not generally observed in reality,
- when the degree of softness is lower than optimal, the results achieved under soft law are worse than those that would be achieved under tough law, and
- when verification is possible and the verification cost is not too high, then the gambling-on-resurrection problem is removed and the results are close to first best.