

Seminar questions for week 39

Please answer question I and II.1 before the seminar and be prepared to present them at the seminar. The rest of the questions will be solved at the seminar.

Question I

Write a short essay (machine written: 3-4 pages) about how current bankruptcy procedures can lead to ex post inefficient outcomes: Firms that should be continued are liquidated or firms that should be liquidated are continued.

Question II

A bankrupt firm has three priority classes of creditors, 1, 2 and 3. Class 1 has priority before 2 and so on: $D_1 = 400$, $D_2 = 300$, $D_3 = 300$. While 1 is a large creditor, the other two classes consist of many small creditors, and so it is not feasible to renegotiate their debt. The liquidation value of the firm is L . The firm had no income in previous period, but will have a certain income of 800 the next period if production is continued.

1. In which of these cases will the firm be refinanced when (i) $L = 500$ and (ii) $L = 100$

(a) Creditor 1 is the only one who considers refinancing the firm

(b) Creditor 3 is the only one who considers refinancing the firm

What is the value of L that would make the creditor indifferent between refinancing the firm or not?

2. Assume now that while D_1 and D_2 are due after the first period, D_3 is due after the second period. How would this affect the firm's chance of being refinanced? How would the type of priority rule matter?

3. In Hart, chapter 7, there is a suggestion for a new bankruptcy procedure. Explain what would happen to the firm if this procedure was followed.