Why Bankruptcy

The Economic Objectives of Bankruptcy Law

• Keep the business going
• Satisfy the creditors to the extent possible

Keep the Business Going

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• This restaurant has a positive cash flow means that its continued existence contributes to GDP

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• This restaurant has a positive cash flow means that its continued existence contributes to GDP
• It is Hicks-Kaldor Optimum to keep it going.

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Why Bankruptcy

Chapter 11

Due the 87th National Bank on a mortgage on the building
$50,000

Due the Internal Revenue Service
$10,000

Due the Employees
$30,000

Due miscellaneous creditors
$30,000

Due Famous Dan's Pies, a specialty of the store
$10,000

Due Acme Venture Capital
$150,000

Assets = $210,000

Liabilities = $280,000

People come to the restaurant because Johnny is a famous raconteur. If another restaurant opened on the same location, it would certainly not do as well.

The right solution is to use Chapter 11 of the bankruptcy law, allowing for a restructuring of the liabilities so as to preserve the assets.

The alternative is Chapter 7, where the assets are sold off to satisfy the creditors to the extent possible.

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• Some one else is willing to pay $275,000 to open a store on the site.

Why Bankruptcy

Chapter 11

• Chapter 11 ends the “rush to the courthouse”
• It gives time for a restructuring and preservation of the going concern value of the building.

Why Bankruptcy

Other Possible Facts

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• Johnny's Restaurant has just been in business a short time and isn't very well known.
• Some one else is willing to pay $275,000 to open a store on the site.
  – Probably never go to bankruptcy court

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Why Satisfy the Creditors

• Our test of a law is Hicks Kaldor Efficiency. Why is it then necessary to satisfy the creditors?
• People do not lose *ex ante* by bankruptcy.
• When there is a risk of bankruptcy, borrowers demand a higher risk premium for lending money and thus recover *ex ante* through a higher interest rate.

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In Johnny’s Case

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• If I lend $100,000 to Johnny's Restaurant, I stand a 3% chance of losing my money.
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• If I lend $100,000 to Johnny’s Restaurant, I stand a 3% chance of losing my money.
• I will want a 10% return from Johnny.
End