

Why Bankruptcy

The Economic Objectives of Bankruptcy Law

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

Keep the Business Going

- We are in the business of creating and preserving wealth, not destroying it.
- 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.

Chapter 11

Due the 87 th National Bank on a mortgage on the	\$50,000
Assets = \$210,000	
Liabilities = \$280,000	
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

Chapter 11


Assets = \$210,000	\$50,000
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.

Chanter 11

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Chanter 11


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The right solution is to Chapter 7, where the assets are sold off to satisfy the creditors to the extent possible. The alternative is to use Chapter 11 of the bankruptcy law, allowing for a restructuring of the liabilities so as to preserve the assets. certainly not do as well.

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Other Possible Facts

- Johnny's Restaurant is losing money

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 - Chapter 7

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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

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 Satisfy the Creditors

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- 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.

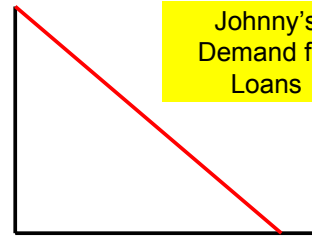
In Johnny's Case

- If I lend \$100,000 to the government I will get 7% on my money
- If I lend \$100,000 to Johnny's Restaurant, I stand a 3% chance of losing my money.

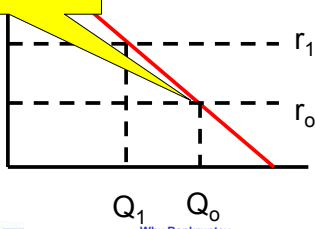
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- If I lend \$100,000 to the government I will get 7% on my money
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- I will want a 10% return from Johnny.

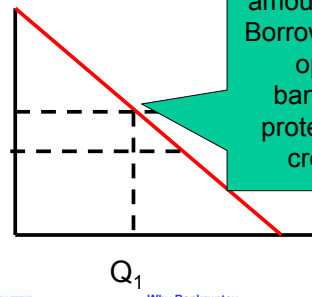
The Cost



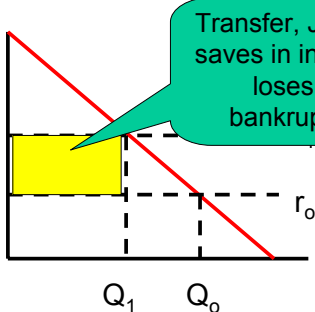
With optimal bankruptcy protection for creditors



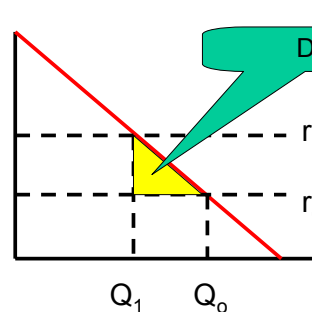
Interest rate and amount Johnny Borrows without optimal bankruptcy protection for creditors



The Cost



The Cost



End

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