The Value of Bankruptcy Enforcement in Financial Distress

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A discussion by

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2024 ABFER Capital Market Development Webinar

First impression

- A very polished paper:
  - This will be the 11th public presentation.
  - I will be the 5th discussant.
- Anything that came to my mind reading the front end was discussed in the paper.
- Results are believable: Hard to imagine that efficient courts or better enforcement of rules could lead to a worse outcome.
- Closet paper: Pontecelli and Alencar (2016) who show that bankruptcy process refinement in Brazil led to increased investment and higher proportion of long-term debt.
- Basic idea: Better bankruptcy enforcement -> higher recovery -> lower cost of debt for given default rate -> effect is stronger among risky firms.

The job of a discussant

- Typically, in 10 minutes:
  - Start with "it is a super interesting paper."
  - End with "I recommend everybody to read it."
  - In between, quibble about some endogeneity and the level of standard error clustering.
- But I have 25 minute.
  - So,
  - I will have time to do what is prescribed. Not only you should read this paper, but also "Going Bankrupt in China" by Li and Ponticelli. In addition, I would like to:
  - Share my experience and thoughts as an informed reader.
  - Point out where I would like to learn more in a scientific discovery process.
  - Think together with the authors where this line of research could be heading.

General institutional questions about "enforcement"

- It will help a broad readership to highlight the common and contrasting features in the bankruptcy process between China and other major economies.

- What is "enforcement?"
  - Most intuitively: Court order gets executed quickly in no deviation.
  - More generally: Debtors bear the consequences in full compliance to the stated rules/laws, so, court orders per se is part of "enforcement," such as enforcing the "absolute priority rule."
  - A related factor: The speed and ease to reach the states described above.
  - Where does a "lengthy and cumbersome" bankruptcy process stand in the way?

What is the nature of the reform?

- What goes into the key independent variable: establishment of independent bankruptcy counts in many cities at different times.

- Do these courts merely improve speed and professionalism, or do they also introduce a doctrinal shift?

- "Weak protection of creditor rights" is not unique to "developing countries."
    - For example, the U.S. bankruptcy law is considered "pro-debtor" for its "debtor-in-procession" process.

- Lengthy bankruptcies are not necessarily pro-debtor: Eastern Airline and Lehman Brothers.

- Not all creditors are the same: A "length and cumbersome" bankruptcy process could be the result of balancing different layers in the capital structure.

Where is the tension?

- It is hard to imagine that efficiency does not bring about better outcomes.

- What are the frictions that prevented specialized courts to be established?

- Who are more eager or better positioned to set up a specialized court? What come to mind: Expected debt-overhang; economic density; talent availability; business friendliness?

- Who want to oppose it? Not clear.

- Table 2 shows: NOTA (None of the above).

- Li and Ponticelli (2022) document that post-specialized-court, firms can still choose between new, specialized court and traditional court. But, nothing predicts the choice.

- But we know that these important decisions could not have been made on a coin flip. Need some affirmative results here.

- Factors that *did* drive the timeliness of court set up at individual places could help with research design.

More into the "black box"

- The analyses generally connect a "regime" change (i.e., a new court) and market-level outcomes (bond spreads, new issuance, etc.).

- Some supportive evidence (e.g., Table 8) on what the courts achieved in economic outcomes (e.g., duration and recovery).

- To the extent that the authors believe that the introduction of courts was exogenous, then it could be used as an instrument for the outcome variables in Table 8, and then make a direct connection between "quality of process" and economic outcomes such as firm performance and bond pricing.

- This would be a more logical specification than Table 7 (interacting Special Court with Recovery).

- In general, more information on what the courts now do differently.

Now, comments about empirics

- This is really "quibbling" as the paper is very carefully executed.
- The dependent variable is at the issue (bond) - year level.
- The key independent variable is at the city - year level.

$$y_{bfct} = \beta \text{SpecialCourt}_{ct} + \gamma Z_{bfct} + \alpha_f + \alpha_t + \varepsilon_{bfct}$$

- Variation within the same city-year cannot be explained by the key variable of interest.
- The reason to adopt bond-level regression is incorporation of more comprehensive controls including saturated fixed effects.
- May want to consider a group-differencing model.

Group differencing model

- First estimate the impact of issue level covariates by differencing out Special Court.

$$y_{bfct} - \overline{y_{ct}} = \gamma \left(Z_{bfct} - \overline{Z_{ct}} \right) + \alpha'_f + \alpha'_t + e'_{bfct}$$

- Then using the "residual average" to estimate the group effect.

$$\overline{[y_{bfct} - \hat{\gamma} Z_{bfct}]}_{ct} = \beta \, SpecialCourtct_{ct} + \alpha_f + \alpha_t + e_{bfct}$$

Conclusion

- A significant contribution to understanding the bankruptcy process in China, and the quantitative importance of the process on economics outcomes in general.

- More narratives on the potential tension and key drivers.

- Highly recommend reading both papers!