

Going Bankrupt in China

Bo Li and Jacopo Ponticelli

Discussion by Yueran Ma

Chicago Booth

ABFER Webinar

Some Thoughts on Bankruptcy

- 1 Bankruptcy institutions are important
- 2 Bankruptcy institutions perform poorly in many countries
- 3 Bankruptcy institutions are not just about laws
- 4 Objectives of legal institutions for bankruptcy

A. Bankruptcy Institutions are Important

Ex post impact:

- Investor protection and contract enforcement
 - ▶ Detect and resolve any fraud, injuries
- Efficient allocation of resources:
 - ▶ Viable firms in financial distress: keep alive and restructure balance sheets
 - ▶ Non-viable firms in economic distress: liquidate and reallocate resources

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Ex ante impact:

- Determinants of firms' debt capacity
 - ▶ What can be enforced ex post affects what contracts can rely on ex ante
- Creative destruction and economic dynamism. Firms' risk taking, innovation.

A. Bankruptcy Institutions are Important

Example: Japan.

Bankruptcy laws and courts not functional for a long time. Few formal bankruptcy filings.

- Could have exacerbated high dependence on banking groups, real estate.
- Likely exacerbated impact of property price collapse, debt ever-greening.

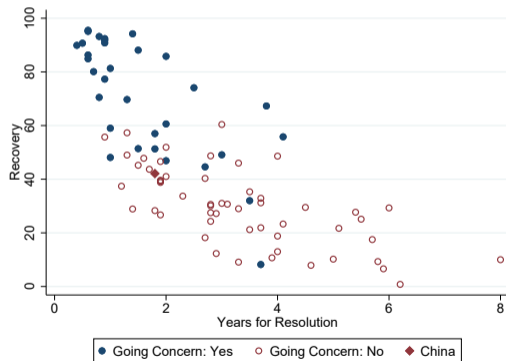
Major bankruptcy reform in late 1990s/early 2000s. Adopted many elements of US Ch11.

- Court-based bankruptcy much more utilized.
- Could have helped capital markets and financial contracts in Japan.

B. Bankruptcy Institutions Perform Poorly in Many Countries

Djankov et al. (2008) presented an example case to legal professionals around the world

- A hotel in financial distress. Worth 100 as going concern; 70 if liquidated.
- Professionals in each country assess most likely resolution scenario.



C. Bankruptcy Institutions Not Just about Laws

Well-functioning bankruptcy institutions require not just statutes. There is a large ecosystem.

- Many countries reformed bankruptcy laws and had limited effects
 - ▶ Reforms of laws have more impact when courts function better (Ponticelli and Alencar, 2016)
- Implementation by judges is crucial (Iverson et al., 2020)
- US: Ch11 filings concentrate in Southern District of NY and Delaware

Highlight of this paper: reforms of courts, not statutes

D. Objectives of Legal Institutions for Bankruptcy

Bankruptcy \neq business failure

Many unsuccessful businesses just shut down.

- Bankruptcy needs petition to start. Business failure does not.
- There is nothing bankruptcy can do to cure a lousy business idea.

Many businesses go through bankruptcy to restructure and continue operations.

- Gilson's textbook title: *Creating Value Through Corporate Restructuring*

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Bankruptcy is commonly viewed as a legal process to resolve financial distress

- Especially when private negotiations not frictionless (Coase theorem)

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Role of bankruptcy (Smith and Stromberg, 2004)

- 1 Verify assets and liabilities
- 2 Improve coordination among claimholders (collective action problem)
- 3 Protect claimants
- 4 Maximize value of businesses and assets
- 5 Alleviate impact of liquidity constraints

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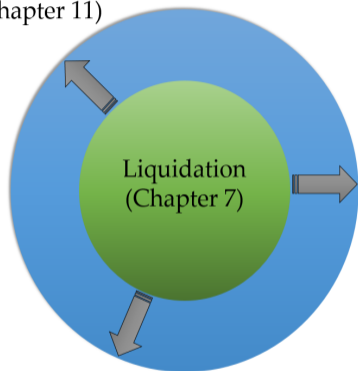
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All objectives rely on laws + implementation

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Reorganization
(Chapter 11)



Large US Chapter 11 cases:

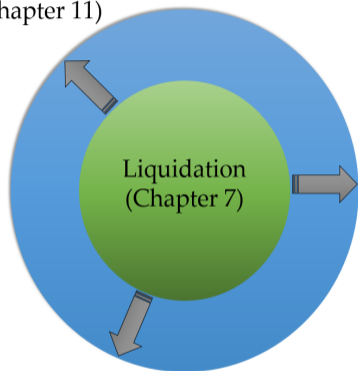
$\text{Going-concern value} / \text{Total liquidation value}$

Median: 2; IQR: 1.3 to 3.1

(Kermani and Ma, 2021)

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Going-concern value/Total liquidation value
Median: 2; IQR: 1.3 to 3.1
(Kermani and Ma, 2021)

In ideal case, bankruptcy institutions serve as hospitals, not funeral homes.

- Bankruptcy \neq insolvency in US; encourages preemptive restructuring.

The China Reform: Introduction of Specialized Bankruptcy Courts

Key features of specialized courts:

- Judges with specialized training in bankruptcy
- More judicial independence (e.g., from local governments)

Main effects:

- Reduce duration (by 125 to 193 days on average, or 23% to 36%)
- Reduce inefficient continuation and slow resolution of SOEs
- Cities have less employment in “zombie” industries, more firm entry

Indicates progress in improving coordination or reducing administrative costs/wastes

#1 Other Metrics

Do the new courts facilitate preserving viable firms?

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Heterogeneous treatment effects by firm size, industry?

- Large firms, certain industries more challenging to handle

#1 Other Metrics

Do firms use court-based bankruptcy more in cities with new courts?

Do new courts improve financing availability in a area?

Do new firms choose to locate closer to the new courts?

- Night lights? Baidu maps?

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Why zombie firms do not exit outside of formal bankruptcy?

- Do better bankruptcy courts reduce banks' propensity to ever-green loans?
- If so why?

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Paper emphasizes that bankruptcies at new vs old courts similar

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- Firms gravitate towards more experienced courts
- International firms also utilize Chapter 11 through US subsidiaries (Gilson 2012)

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Is it ultimately desirable to allow more forum shopping?

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- Training of judges with specialized knowledge important
- Separate court may enhance judicial independence
- Reform influences both ex post and ex ante economic outcomes
 - ▶ Analyzing more outcomes would be useful, if they can be measured

What Else Could Help?

Bankruptcy resolution relies on a large ecosystem

- Creditor/investor sophistication
 - ▶ Contract design, monitoring of firms' performance, financing availability post filing
- Non-bankruptcy institutions—inseparable from bankruptcy institutions
 - ▶ Accounting/auditing ⇒ affects verifiability and contractibility
 - ▶ Corporate governance more generally ⇒ affects agency problems
 - ▶ Non-bankruptcy laws ⇒ affect rights of creditors and debtors
- View of bankruptcy: should be a tool, not a stigma
 - ▶ The word “bankrupt” has negative connotations
 - ▶ What about “Bankruptcy Reforms beyond Statutes: Evidence from China”?
 - ▶ “Going bankrupt” ⇒ “filing for bankruptcy”?