Financial Distress and Bankruptcy Costs

MM assume away bankruptcy (or finanncial distress) costs in their work on capital structure theory. What happens if this assumption is relaxed? Does this put a limit on the use of debt? We explore this question in the following paragraphs.

Bankruptcy involves the transfer of ownership of a firm's assets from the firm's stockholders to the firm's bondholders. Ownership is transferred if the firm cannot meet its financial obligations to the firm's bondholders and other lenders. Bankruptcy involves the costly services of lawyers, accountants, and administrators. Some people refer to bankruptcy costs as "deadweight costs" because they take financial resources out of the firm, away from both bondholders and stockholders.

Prior to actual bankruptcy, the firm may experience financial distress. Financial distress is a more general term than bankruptcy and may refer to a situation where a firm is experiencing difficulty meeting its interest and principal payments and paying its other bills. The firm may attempt to restructure operations or renegotiate lending agreements in order to meet debt obligations.

Bankruptcy costs can be direct or indirect. Direct costs include lawyer and accountant expenses. Indirect costs include lost business due to decreased customer and supplier confidence, foregone opportunities due to managers focusing on the bankruptcy and not on the core business, and increased human resources costs due to employees leaving for more secure jobs. The present value of future expected bankruptcy costs is factored into firm value. Reference Lecture Slides 8 - 10 for numerical illustration on expected bankruptcy costs.

Financial distress or bankruptcy is a problem associated with the use of debt financing. The more debt a firm has, or the more volatile its cash flows are, the higher the probability of bankruptcy.

Since expected bankruptcy costs = f(bankruptcy costs; bankruptcy risk), we can examine characteristics of firms that face higher bankruptcy costs. Firms with mostly liquid and tangible assets have lower bankruptcy costs than firms with a large fraction of illiquid and intangible assets. Think about innovative technology firms, may they be in biotechnology, computer technology or internet technology. Do they have high or low debt ratios in general? Firms with stable and predictable operating income have lower bankruptcy risk than firms with uncertain or volatile operating income. Think about traditional utilities firms, may they be electric or gas companies. Do they have high or low debt ratios in general? Another way to reduce bankruptcy is debt consolidation. When multiple creditors are involved, bankruptcy costs are higher due to negotiating and legal fighting. With consolidated loans, these costs are reduced.