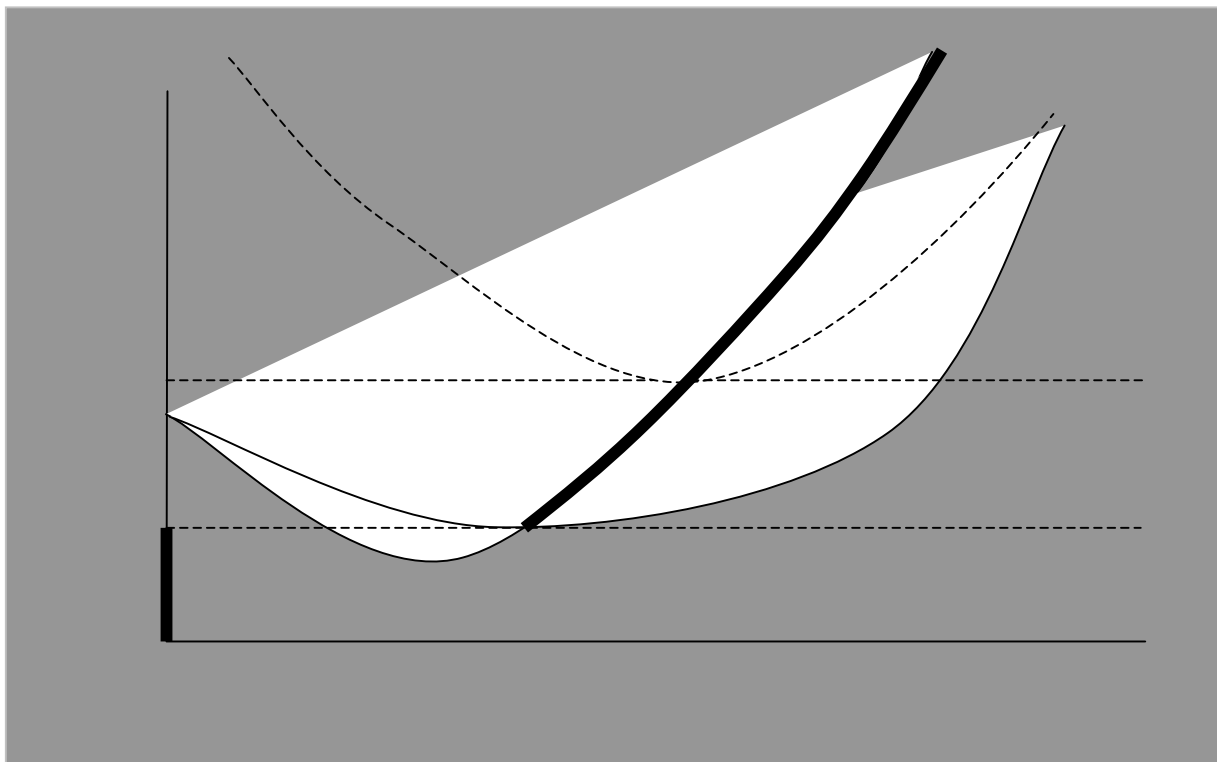
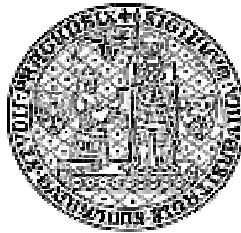


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Bankruptcy Law Design?



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The extensive economic research of bankruptcy within the last decade has made many issues connected with bankruptcy legislation much clearer but there is still a large area of disagreement about how an optimal bankruptcy law should look like. At the same time, the actual bankruptcy laws in various countries differ substantially and there is an agreement that there is no one-size-fits-all solution. This paper sets stage for the debate about the optimal bankruptcy law design in the Czech Republic. It shows what problems arise in connection with bankruptcy, what methods can be used to solve them, and what are the trade-offs faced by the use of individual methods. First, the question why bankruptcy legislation is needed at all is answered. Further, three mutually intersecting approaches to the determinants of optimal bankruptcy law design are presented: concepts of ex-post and ex-ante efficiency, principal-agent theory view, and the emphasis on judicial corruption problems within different bankruptcy designs.

Keywords

bankruptcy, capital and ownership structure, ex-ante and ex-post efficiency, asymmetric information, moral hazard, judicial corruption

Introduction

The last decade has witnessed a surge in the economic research of bankruptcy. Thanks to this research, many things have become much clearer but there is still a large area of disagreement about how an optimal bankruptcy law should look like. At the same time, the actual bankruptcy laws in various countries differ substantially in many respects. These differences reflect the path-dependency of the economic and institutional development. Although we may hope that the future research will help us design better bankruptcy laws, there will never be something as a generally applicable best solution. As Hart (2000) notes with respect to bankruptcy laws:

it is unlikely that “one size fits all.” That is, although some bankruptcy procedures can probably be rejected as being manifestly bad, there is a class of procedures that satisfy the main criteria of efficiency. Which procedure a country chooses or should choose may then depend on other factors, e.g., the country’s institutional structure and legal tradition. (Hart, 2000: 1)

In the present paper we want to set stage for the debate about bankruptcy in the Czech Republic. Our goal is to show what problems arise in connection with bankruptcy, what methods can be used to solve them, and what are the trade-offs faced by the use of individual methods.

Before we start with the agenda outlined above, one disclaimer needs to be made: we do not claim the right to determine what should be the goal of the bankruptcy law, in particular, whether it should be to achieve pure Pareto efficiency or whether pure efficiency should cede to some distributional goals. This question should be answered by politicians. Our ambition, instead, is to discuss the consistency of various designs with different possible goals of bankruptcy laws.

In the first section of the paper, we answer the question why bankruptcy legislation is needed at all. In the following parts, we present three mutually intersecting approaches

to the determinants of optimal bankruptcy law design: concepts of ex-post and ex-ante efficiency, principal-agent theory view, and the emphasis on judicial corruption problems within different bankruptcy designs. The last section concludes.

1. The Need for Bankruptcy Law

The first question is: Do we really need a bankruptcy law? And if yes, why do we need it? Bankruptcy laws certainly represent a state intervention in the contracting freedom. They restrict the set of ex-ante feasible contracts by preventing the parties from contracting for the case of bankruptcy. Any contract clauses stipulating the rights and obligations of parties in bankruptcy or concerning the right to file for bankruptcy are invalid. In a standard Arrow-Debreu economy without externalities and other market failures, such restriction would be harmful to Pareto efficiency. Therefore, the economic justification for bankruptcy law, if any, must consist in the presence of *market failures*.

Standard justification says that bankruptcy law is needed to resolve the situation where the creditors' claims are mutually inconsistent, i.e., there are *more creditors* and there is not enough assets to compensate all of them according to their contracts. Without the automatic stay on individual debt collection in bankruptcy, creditors would be motivated to „run on assets“ in order to be the first to collect. The Nash equilibrium resulting from their optimal individual strategies would not be socially optimal. This particular market failure represents a usual explanation for the need of a bankruptcy law.

Given that agents are rational, we should ask why firms have more creditors at all when the suboptimality of the market outcome would not arise if each firm had a single creditor. The answer to the question of creditor multiplicity can be found in several papers on financial contracting. Berglof et al. (2003), for example, develop a model in which the creditor multiplicity is not a result of chance but is determined endogenously. Because of the costs incurred ex-post in the presence of multiple creditors, the incentives of the debtor to default strategically are reduced. This, on the other hand, increases the debt capacity of the firm. In their model, the inefficiency ex-post increases the efficiency ex-ante and the problem is to find the optimal trade-off between these two.¹

The question that follows, given agents' rationality and creditors' multiplicity, is why the mechanism for the resolution of the debtor's default cannot be stipulated in a contract. Here, the usual answer is that all contracts are necessarily *incomplete* – they do not specify optimal actions for all the states of the world, simply because it is not possible to foresee ex-ante all the states that can occur, to describe them in a contract, and to specify optimal actions for all these states. Therefore, the actual contracts are either not state-dependent at all or they only specify actions for a small subset of possible states.²

According to the above standard argumentation, the multiplicity of creditors is consistent with rationality and cannot be solved by a contract. Does this really imply that there must be a single state-provided bankruptcy system? Hart (2000), for example, proposes that companies be allowed to opt out from the state bankruptcy procedure. If

¹ For the discussion on the concepts of ex-ante efficiency vs. ex-post efficiency, see Chapter 2 below.

² Some authors, however, cast doubt on the argument with contract incompleteness. Maskin and Tirole (1999) show that contract incompleteness would not have to be a problem for rational agents because mechanisms exist that enable them to achieve the same payoffs as those that would be specified in a complete contract.

they can agree with their creditors, there is no reason why they should be prevented from selecting their preferred procedure. The only problem one can think of in connection with this possibility is the protection of certain creditors, in particular those who have not become creditors from their own will (such as tort claimants or tax authority) and those who are in a weaker position with respect to the company, such as workers. These classes of creditors could be protected by requiring that they could not receive worse treatment than under the default bankruptcy regime, represented by the state bankruptcy law. With some imagination, one can assume that organizations such as business chambers which operate dispute resolution panels would start to provide their own insolvency proceedings and the competition among them would keep down the costs and push up the speed and quality of the services provided. The bottom-line is that although the incomplete contracts argument may be valid, it need not justify the exclusivity of state-provided bankruptcy regimes.

It is clear from the argumentation above that the bankruptcy law necessarily interferes to the individual rights of creditors. However, we can observe different degree of this interference to creditors' rights in different bankruptcy law designs around the world. In general, we can distinguish between bankruptcy systems that are tough on debtors (i.e., assigning strong control rights to creditors) and those that are soft (i.e., limiting creditors' rights substantially). Existing bankruptcy laws range from extremely tough to extremely soft. In this paper, we discuss what drives the optimal bankruptcy law design to be softer or tougher.

2. Ex-ante and Ex-post Efficiency

An important consideration in connection with the assessment of a bankruptcy law quality is one distinguishing between its ex-ante and ex-post effects. Quite often, analyses of bankruptcy laws deal only with the latter ones, looking at what happens after the bankruptcy is declared. The institution of bankruptcy, however, does not affect purely a certain fraction of firms in the economy that go bankrupt (ex-post effect). The indirect effects on the rest of the economy take place through the possibility of bankruptcy in the future (ex-ante effect).

The ex-post efficiency criterion requires that a socially optimal solution be implemented after the bankruptcy occurs. For several reasons, giving control to creditors may not guarantee that such a solution will be achieved. For example, social optimality may involve cancelling most of the debt and leaving the debtor (debtor's management) in control because he most likely has better information than anybody else, including the creditors, about what to do with the firm.³ Another reason for ex-post inefficiency of giving full control to creditors is that the socially optimal solution may be different from the one that would maximize the market value of the firm, i.e., value available for creditors. This situation arises in the presence of externalities created by the firm, which the creditors would not internalize. Thus, they could liquidate the firm, although it would be socially optimal to reorganize it and continue with operation.⁴ A common feature of these two examples is that they involve an interference with the creditors' rights in the name of social optimality. However, (leaving aside the fact that „social optimality“ may

³ See, for example, Berkovitch and Israel (1999).

⁴ See, for example, Biais and Recasens (2002).

be used to justify other, purely private interests) they still represent just one side of the coin – ex-post efficiency.

To account for ex-ante efficiency as well, one has to consider how creditors adjust their behavior in the pre-bankruptcy stage, if they assume that their interests will not be adequately respected within bankruptcy. How the effort to achieve the optimal solution ex-post will affect the willingness of creditors to borrow ex-ante? If there are substantial distortions, then the exclusive focus on ex-post optimality may cause a significant harm to overall optimality. Some projects with positive net present value will not be financed because the net value that the creditors can extract from the project is negative due to the breach of their rights in bankruptcy.

Soft bankruptcy law will also affect creditors' actions once they did finance the project. The risk of bankruptcy, in which they may suffer substantial losses, induces them to negotiate such contractual terms with the debtor that allow them to liquidate endangered projects as soon as first signs of potential problems appear, even though this may be connected with losses as well. Therefore, some viable projects may be liquidated.

Soft bankruptcy laws also affect the actions of the debtor or its management. Knowing that she can keep control in bankruptcy, the debtor will be less motivated to avoid it. This further aggravates the moral hazard problem connected with debt financing because the debtor will be motivated to follow more risky strategies.

On the other hand, an ex-post efficient soft bankruptcy law has some positive ex-ante effects, too. It provides creditors with stronger incentives to monitor the debtor. Given the free-rider problem connected with monitoring, the stronger monitoring creates positive externalities for other stake-holders who benefit from the due management of the firm (e.g., shareholders, workers or the tax-collector). If the bankruptcy becomes very likely or even inevitable and the law is tough on the debtor, the same factors that served to discipline the management in a sound firm may now play a different, undesirable role. Because tough laws give control and cash flow rights in bankruptcy to creditors, the distressed firms have little to lose and their managements are motivated to choose „all or nothing“ strategies that have very high probability of failure but in case of success can keep the firm alive. The debtor may even try to divert assets and cash flows from the distressed firm to her other projects.

We, however, believe that the negative ex-ante effects of a soft bankruptcy law prevail over the positive ones. First, the net effect of the stronger monitoring by the creditors may be smaller because shareholders may decrease their monitoring efforts and rely more on the monitoring by the creditors. Second, the aggravated moral hazard problem under a tough bankruptcy law can be partly mitigated by including sanctions to the management for actions reducing or endangering the value of the firm. In addition, this aggravated moral hazard problem concerns only a small part of businesses which become distressed.

The bottom-line of the above discussion is that there is a trade-off between ex-ante and ex-post efficiency. Although a soft bankruptcy law may lead to better results ex-post, it has negative effects ex-ante. Where on the scale between absolutely soft and absolutely tough the law should optimally be, depends on various factors.

In calm economic periods, bankruptcy is rather a rare event and, more importantly, the firms that go bankrupt are usually those that are economically, not only financially distressed. The distinction between economic and financial distress is crucial. It relies on

the causes of the firm's inability to repay its debt. Economic distress means that the firm's capital and labor are not used optimally and it would be Pareto improving if these resources were freed from this inefficient use and put into another use. This may be best achieved by a liquidation of the firm involving an auction of the firm's individual assets, or by a sale of the firm as a going concern (for example, if the economic distress is only due to shortcomings at the top-management level), or by combination of these two, i.e., by selling some part of the firm as a going concern and by liquidating other parts. Which of these possibilities will be chosen should depend on the proceeds associated with each of them.

The financial but not economic distress, on the other hand, is not caused by shortcomings in the firm's operations but usually by some shock to the its capital structure. For example, in periods of macroeconomic turbulences, like those in Asia in the end of 1990s, economically sound firms may become insolvent if their debt is denominated in foreign currency and the local currency depreciates substantially. Liquidating the firm in this situation would not be socially optimal. In this case, a hard law can imply social losses in the form of more frequent liquidations. On the other hand, soft law, which provides a protection to the debtor before the creditors, can help the affected firms survive the turbulent times and, in the end, can even lead to higher payoffs to the creditors.

For such situations of systemic distress, Stiglitz (2000) suggests a *Super Chapter 11*, a special chapter in a country's bankruptcy code, which would stay dormant in calm times and would only be activated in the periods of macroeconomic turbulences. Like the valid U.S. Chapter 11, the main characteristic of the proposed law would be that the debtor would stay in control during reorganization and the capital structure would be adjusted, usually by means of a debt-equity swap. According to Stiglitz (2000), *the Super Chapter 11* would have to meet the following requirements to effectively address the systemic distress:

- (1) to set strict time-limits for courts to rule and sanctions for those attempting to delay;
- (2) to be soft on the incumbent management and the old shareholders, giving them sufficient equity stake in the reorganized firm in order to provide them with adequate incentives; and
- (3) to determine a wide set of default provisions or guideline provisions in order to facilitate the resolution.

Although this is an interesting proposal, its potential consequences would have to be carefully investigated before its introduction. There are number of issues connected with this proposal. Who should decide about the activation of the *Super Chapter 11*? What would be the criteria for the activation? Would there be some maximal term after which the Super Chapter 11 would automatically be de-activated? And many others.

Biais and Mariotti (2003) consider different factors that affect whether rather soft or tough bankruptcy law will be optimal. They build a general equilibrium model and study interactions between the credit and labor markets. The agents in their model are heterogenous and differ by their initial wealth level. A tough law may be desirable because a soft law leads to credit-rationing – it worsens access to credit for relatively poor agents because it gives the judge the opportunity to decide for continuation even

though the creditors would prefer liquidation. Due to credit-rationing, the aggregate level of investments is lower, which reduces the demand for labor. In addition, the labor supply is increased because some agents who would prefer to become entrepreneurs have to become workers (they do not have access to credit). The lower demand for and higher supply of labor lead to lower wages, which hurts also the poorest agents who could not become entrepreneurs even under tough law. Therefore, in this way, the soft law is harmful especially for middle-class and poor agents. Rich agents need relatively little debt financing, which they can raise even under soft law. They benefit from the possibility, provided by the soft law, to avoid liquidation in the case of default.

The soft law, however, may be optimal as well because it reduces a negative externality generated by the interactions of the credit and labor markets in the presence of moral hazard. In order to reduce the moral hazard of the debtors-entrepreneurs, relatively poor entrepreneurs need to pledge high portions of their income. If the law is tough, it may enable all agents who wish to start entrepreneurship to do so (there is no credit-rationing) but they have to issue risky debt and commit to high liquidations in case of default. The absence of credit-rationing means that the marginal entrepreneur is indifferent between becoming an entrepreneur or a worker. The marginal entrepreneur, by deciding to become an entrepreneur, increases the overall demand for labor and thus wages. There is a negative externality for the other entrepreneurs generated by this decision. Their pledgeable income decreases and they have to commit to higher liquidations in case of default. This increases the frequency of inefficient liquidations and thus reduces social welfare. The soft law, by introducing some credit rationing, would improve social welfare because this negative externality would be partly eliminated.

The point that Biais and Mariotti (2003) make is that some credit rationing may be desirable because it reduces the amount of inefficient liquidations. On the other hand, because credit rationing also leads to lower investments and lower wages, too much of it is harmful. The optimal law, therefore, should optimally trade-off these two effects. The whole analysis in Biais and Mariotti (2003) is built on the assumption that continuation is efficient while liquidation is not. The case for the tough law is the stronger the more often this assumption is not met.

3. Principal-Agent Problems in Bankruptcy

In this section we continue the discussion of market failures arising in connection with bankruptcy by studying the issues of asymmetric information and principal-agent problem. Because bankruptcy means a violation of the creditors' contracts, one can argue they should have control over the bankruptcy procedure. For various reasons, one of which is the asymmetric information problem, existing bankruptcy systems limit the control rights of creditors. The extent, to which the creditors' right are limited, varies significantly across countries. Under tough laws, such as the German or British, important decisions cannot be made without the creditors' consent. Under soft laws, such as the U.S. Chapter 11 or the French bankruptcy law, it is often possible to proceed against the creditors' will, if the court so decides. Neither under tough nor under soft laws, the creditors are involved in the administration of the insolvent firm directly but only through some agent (either the original management in reorganizations or the bankruptcy trustee in liquidations) and, therefore, under both regimes there arise

principal-agent problems. These problems are more severe under soft laws, which allow for the reorganization procedure.

The principal-agent problem arises both in connection with the initiation of bankruptcy and during the bankruptcy procedure. Under a tough law, the management is not positively motivated to initiate bankruptcy because its powers are stayed and it loses control and income associated with its position. Therefore, the management usually files for bankruptcy later than would be optimal, when the debts are already much higher than the assets. Sometimes, when the creditors file for bankruptcy, the management uses various tools to defend and to postpone the declaration of bankruptcy as long as possible.

Under a soft law, like the U.S. Chapter 11, the problem is the opposite. Even businesses that could be able to repay its debts file for Chapter 11 reorganization, because the management is not left out of control and the procedure enables to cancel part of the debt, which can benefit the shareholders. It is again a question of particular, country-specific parameters which problem, whether the late initiation or abuse of bankruptcy to escape creditors, will be more serious.

In reality, only a narrow group of insiders may know what are the prospects of an insolvent firm in reorganization and how much could yield the auction of its assets. It is usually the management who has the best information but the management need not always act in the interest of the relevant stakeholders (creditors, employees, and also shareholders, if there is a chance that there could be something left for them after the bankruptcy) and the problem is how to provide the managers with the right incentives. On the other hand, the creditors generally have the right incentives but they may lack the relevant information and, as a consequence, may make wrong decisions. In addition, although the creditors will generally be the major stakeholders in a bankrupt firm, other parties, such as employees or suppliers, may have some stakes in it as well. Giving full control to creditors usually means that the interests of these other parties will not be accounted for.

For bankruptcy, this implies a trade-off. Should we trust the management that it will act honestly, try to maximize the value of the firm and to carefully balance the interests of *all* the relevant stakeholders? Or are the losses due to the principal-agent problem so significant that it is socially less costly to give control to creditors? The optimal resolution of this tradeoff will depend on the parameters of individual economies.

The U.S. Chapter 11 is the best known example that solves the trade-off between information and incentives in favor of information. It is based on the assumption that creditors would often choose inefficient liquidation and, therefore, it is better to give the debtor a chance to reorganize the firm, i.e., to increase the efficiency of its operations and to optimally adjust its capital structure. In the U.S., the potential conflicts of interests and other incentives problems are to a great extent mitigated by the supervisory role of the judge who is usually able to prevent the most flagrant abuses of control by the management and other actions harming the creditors. Nonetheless, Chapter 11 procedure is also often subject to critique in the U.S. because abuses occur under its protective wings and they are not rare.⁵

For firms in bankruptcy, it is important to distinguish whether they are economically or only financially but not economically distressed. If the firm is only financially

⁵ A well-known example of such an abuse, which significantly decreased the payoff to creditors, is the bankruptcy of Eastern Airlines. See Weiss and Wruck (1997).

distressed, it may be important, in order to save its value, to continue operation even though it is temporarily loss-making. If the firm is economically (permanently) distressed, continuing loss-making operation reduces the value available for creditors. The optimal solution is to shut the firm down and auction off its assets. However, this distinction is only rarely clear and usually depends on subjective assessments. The management has the incentives to claim that the firm is viable in the long run and it can usually support this claim by powerful arguments because of its insider position.

Under Chapter 11, the typical reorganization chapter, if the management can successfully make this point, the judge can allow the proceeds from asset sales, otherwise reserved for creditors, to be used to fund further operation. Alternatively, the management can continue to operate the firm by means of the so called debtor-in-possession financing, which also requires the consent of the judge, because the resulting debts have priority over all pre-bankruptcy claims. It is clear that in these cases, the pre-bankruptcy creditors can be harmed severely. Weiss and Wruck (1997) call these practices „court-endorsed asset-stripping.“

Principal-agent problems arise also between the creditors and the judge. Although by the law, the judge is not supposed to act as an agent of creditors, in many situations he actually does, e.g., by deciding on issues concerning the management of the insolvent firm that directly affect creditors' payoffs. It is therefore important to what extent the judge is bound by the law in particular decisions. If the law prescribes in detail how to decide, the judge will not be able to account for specific factors of individual cases and he may be forced to adopt inefficient decisions. On the other hand, giving the judge wide discretion may lead to rent-seeking problems because the parties can try to bribe him.

For example, in Chapter 11 the judge has large discretionary powers. He decides on many issues that directly affect the position of individual creditors or of creditors as a whole. Although corruption problems are not a major issue, a problem which is often criticized is that the outcome of the bankruptcy procedure crucially depends on the opinions and attitudes of the judge. Some judges or whole court districts are well known to be pro-debtor oriented in their decision making. This leads to the so called *forum shopping*, which means that debtors do not file for bankruptcy in the place where they have their official seat or principal business but use various legal tools so that they can file in their favored court.

4. Judicial Corruption

Until recently, virtually all researchers in the field of economics of bankruptcy considered the debtor and the creditors (of different types and classes) as the only players of the bankruptcy game, implicitly assuming that the judge is either just an enforcing mechanism or a benevolent agent who maximizes social welfare. When the degree of judges' discretion was discussed, the arguments stemmed from the ability of judges to find optimal solution for several issues they decide on, leaving aside their motivation.

It is an important characteristic of the soft law that it provides the judge with high discretionary powers. If the soft law is to have positive effects, it is important that the judge is benevolent – acts to maximize social welfare. If the judge is corrupt, the discretion given to her may be abused to satisfy particular interests. This reduces both ex-ante and ex-post efficiency. The ex-ante efficiency is reduced because of uncertainty how

the judge would decide if the bankruptcy were declared, which prevents the parties to adjust ex-ante their relationship to the possibility of bankruptcy. Ex-post efficiency is reduced because the solution adopted does not necessarily aim to maximize social welfare. Two different treatments of the effects of corruption in the bankruptcy procedure are Biais and Recasens (2002) and Lambert-Mogiliansky et al. (2003).

Biais and Recasens (2002) study the trade-off between soft law (debtor oriented) and tough law (creditor oriented) bankruptcy regimes. The authors develop a model based on a simple corporate finance model by Holstrom and Tirole (1997). Within the model, under a tough law any insolvent firm is liquidated, while under a soft law a judge decides whether an insolvent firm be liquidated (with the liquidation value going to creditors) or reorganized (with the reorganization payoff going to managers in the form of a nontransferable cash flow). The authors emphasize that excessive liquidation is socially costly in the sense of non-utilization of firm-specific capital and breaking functioning networks. This social cost argument would favor a soft law. However, giving the decision power to a judge that should take into account observed social costs, reduces creditors' expected payoff and, thus, implies credit rationing.

However, the main contribution of the authors is their inclusion of the possibility of corruption among judges in this model. A clear result of the model is that once judges are corrupt, tough law is socially preferred to soft law because the soft law's advantage of the efficient scope of liquidation is gone. In other words, in the presence of high judicial corruption, the soft law generates more credit rationing.

Lambert-Mogiliansky et al. (2003), inspired by their observation of the Russian bankruptcy procedures' outcomes after a new law of 1998 implemented Chapter-11-like reorganization, discuss what is the effect of the capture of judiciary on the behavior of agents under the U.S.-like bankruptcy law design. The authors show in their model that when the judiciary is captured, the manager has no incentives to restructure and the debt to the outside investor is not repaid. Instead the threat of bankruptcy to perpetuate insolvency in a collusive deal between the manager and the governor. The theoretical analysis is accompanied with an empirical verification on the data of Russian firms, which confirms the results. Thus, while using a different setup than Biais and Recasens (2000), Lambert-Mogiliansky (2003) reach the same recommendation for countries with high degree of judicial corruption – to adopt a tough bankruptcy law that assigns minimum powers to the debtor and minimum discretion to the judge. This result is very simple and strongly intuitive but the emerging literature on the role of corruption connected with bankruptcy promises to improve our understanding on trade-offs between soft and tough laws under different country-specific circumstances.

Conclusion

At the beginning we emphasized that when designing a bankruptcy law, it is important to decide what goals the law shall achieve. Shall the goal be to maximize the economic performance by shutting down inefficient firms and freeing their resources for a more efficient uses? Or is maintaining employment in the short run also important? Or are still other goals relevant? A benevolent social planner would chose a law whose only goal is to maximize Pareto efficiency. Such a law would promote a stable and high economic growth and high level of employment in the long run. In the short run,

however, it could cause some painful situations connected with failures of large firms employing many people. Because political economy factors are important in reality, the bankruptcy laws usually differ from those that would be chosen by a benevolent social planner. The politicians operate in a short time horizon and goals of long-term efficiency are often out of their sight.

The Czech Republic is no exception in this sense. It can be argued that the main problem of the current Czech bankruptcy law is that it is rather soft towards debtors in its effects (although it might seem formally tough as it does not allow for reorganization). However, the draft version of the new bankruptcy law that has been prepared by the Ministry of Justice during the last three years is even softer, with the emphasis on maintaining employment. Although we do not want to make a general judgement that tough law is, in all circumstances, better for the long-run efficiency (such a judgement would not be justified given the current state of the research in this topic), the conditions prevailing in the Czech Republic speak rather in favor of a tough law. The heavy dependence of the Czech economy on debt rather than equity financing makes the problem of credit rationing stemming from ex-ante inefficiency more severe. Maybe even more strikingly, the state of the Czech judiciary gives rise to doubts how the judges will use the discretion awarded to them by the proposed law.

Definitely, more research – both theoretical and empirical – is needed, so that we are able to make clear conclusions. While in the international literature the research in this field has grown rapidly during the last decade, the Czech Republic still waits for a serious research in bankruptcy to come.

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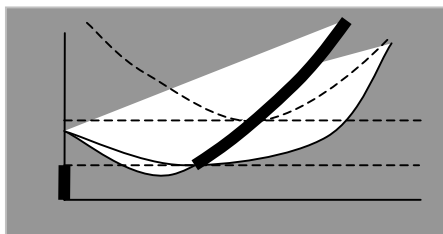
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