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Mai Daher

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Mai Daher

*368A Olayan School of Business
American University of Beirut PO Box 11-0236
Riad El Solh 1107 2020
Beirut, Lebanon
Email: md88@aub.edu.lb*

Abstract

I investigate whether the impact of financial covenant violations on corporate financing policy varies across countries depending on differences in legal enforcement. Covenant violations trigger creditors to use their contractual acceleration and termination rights to increase interest rates or halt any further supply of credit. For a sample of 518 firms in 28 countries, I find that the presence of strong enforcement alleviates a reported decline in net debt issuance following a covenant violation by close to 10%. The results are robust to alternative specifications, the inclusion of a number of control variables and country characteristics, and the use of alternative proxies for legal enforcement and creditor rights. This paper identifies a novel channel, debt covenants, through which creditors respond to the contracting environment, and emphasizes the importance of legal enforcement to financing activity.

Keywords:

Control Rights, Enforcement, Judicial Effectiveness, Financing Policy, Capital Structure, Creditor Rights
G15, G32, G21, K12

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