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Michi Nishihara, Takashi Shibata

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Dynamic bankruptcy procedure with asymmetric information between insiders and outsiders *

Michi NISHIHARA†, Takashi SHIBATA‡

Abstract

We develop a dynamic model in which a distressed firm optimizes the bankruptcy choice and its timing. When the distressed firm's shareholders sell the assets, they are better informed about the asset value than outsiders are. Most notably, we show that this asymmetric information can delay the asset sales to signal asset quality to outsiders. More debt and lower asset value can reduce the signaling cost and mitigate the asset sales delay. We also show that the firm changes the bankruptcy choice from selling out to liquidation bankruptcy when the signaling cost associated with selling out is high. This distortion in the bankruptcy choice greatly lowers the debt value, whereas it has a weak impact on the equity value.

JEL Classifications Code: D82; G13; G33.

Keywords: bankruptcy; adverse selection; asymmetric information; signaling game; real options; M&A.

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†Corresponding Author. Graduate School of Economics, Osaka University, 1-7 Machikaneyama, Toyonaka, Osaka 560-0043, Japan, E-mail: nishihara@econ.osaka-u.ac.jp, Phone: 81-6-6850-5242, Fax: 81-6-6850-5277

‡Graduate School of Social Sciences, Tokyo Metropolitan University, 1-1 Minami-Osawa, Hachioji, Tokyo 192-0397, Japan, E-mail: tshibata@tmu.ac.jp, Phone: 81-42-677-2310, Fax: 81-42-677-2298

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