Strategic Leverage and Employee Protection in Bankruptcy

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Abstract

The seniority of employees’ claims relative to other creditors in the liquidation of insolvent firms, and their rights in the renegotiation of their debt varies greatly across countries. Using a simple model, we show that the balance between these rights of employees and those of other creditors affects the strategic value of debt: in equilibrium, stronger employees’ seniority rights in bankruptcy liquidation increases firm leverage, unless bankruptcy costs are very high or the workers’ claim are senior to all other debt. Moreover, employees’ seniority invariably increases the response of leverage to increases in the value of its assets and in its cash flow. Conversely, stronger employees’ rights in the renegotiation of corporate debt are predicted to decrease firm leverage. To test these predictions, we construct novel measures of employees’ protection in bankruptcy via questionnaires to law firms and other sources, and investigate whether these measures affect the response of firm leverage in a sample of 12,445 companies in 28 countries between 1988 and 2013. We find that increases in the value of these firms’ real estate is associated with a greater increase in leverage for companies located in countries where employees have stronger seniority in company liquidation and weaker rights in debt renegotiation, as predicted by the model. For a subsample of 928 mining and oil companies, we find a similar differential response of leverage to profitability shocks resulting from changes in the prices of the commodities produced by these companies.

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