# Improved Creditor Protection and Verifiability in the U.S.

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**Abstract**

Out-of-court renegotiation is affected by strategic uncertainty among lenders, which, along with debtor's uncertainty about the coordination outcome, makes out-of-court restructuring hard. However, in-court reorganization is also difficult: The verifiability of assets in place by the bankruptcy court can be limited. Building on the work of Bolton and Scharfstein (1996) and Diamond (2004), we develop a model that incorporates these frictions and examine the effect of verifiability on Chapter 11 filings and debt capacity. We test these predictions exploring an exogenous variation in the ability of courts to price assets in place. We use the natural experiment provided by a Supreme Court ruling in 1999 stating that, whenever old equity holders propose a plan in which they contribute new value and keep an interest in the reorganized entity, the plan must be exposed to a "market test" by allowing creditors to propose competing plans. Our results strongly support our predictions. Chapter 11 filings for affected firms more than doubled after the Supreme Court ruling (from 0.63% to 1.73%), while control firms remained largely unaffected. Results are robust to various specifications and tests. Our theory and empirical work help clarify and quantify some of the channels by which creditor protection increases firm value.

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