

THE IMPORTANCE OF BANKRUPTCY COSTS IN FIRMS' CAPITAL STRUCTURE DECISIONS

Gerald R. Jensen, Ph.D.

University of Nebraska, 1988

Adviser: Thomas S. Zorn

Several theories have been developed to explain a firm's capital structure decision. These theories attach varying degrees of importance to bankruptcy costs, ranging from the assumption that bankruptcy costs are insignificant to the assumption that bankruptcy costs, alone, limit a firm's use of debt.

While the significance of bankruptcy costs has been debated in theoretical analyses, the importance of bankruptcy costs to a firm's capital structure decision is ultimately an empirical question. There is little empirical evidence either supporting or refuting the claim that bankruptcy costs affect a firm's use of debt. The purpose of this analysis is to provide a clear description of what constitutes bankruptcy costs and then to test for the importance of these costs to a firm's choice of debt level. Specifically, this analysis tests for the significance of a group of variables to determine whether bankruptcy costs are insignificant, whether they are only part of the reason firm's limit their use of debt. Several authors have suggested that in imperfect markets a firm's financial decisions are likely to be interdependent. This analysis employs a three-stage least squares (3SLS) methodology to test for the factors that are significant in explaining firms' debt ratios. The system equation estimation techniques, such as 3SLS, are standard in studies of changes in firms' financial ratios, however, this analysis is the first to apply this technique to a firm's long term financial decisions.

The findings of this analysis indicate that bankruptcy costs are neither insignificant nor are they the sole factors that determine a firm's debt ratio. The results support a more general theory of capital structure that considers bankruptcy costs in conjunction with other factors as the determinants of a firm's capital structure. Specifically, the Modified Pecking Order Theory explains many of the relationships observed in this analysis and warrants more consideration in future discussions of firms' capital structures.