Anatomy of Out-of-court Debt Workouts for SMEs*

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Abstract

In this study, we use a detailed and comprehensive dataset on out-of-court debt workouts for distressed small and medium-sized enterprises in Japan to describe characteristics of these workouts. We then investigate their determinants and the subsequent effects on firm performance. We find that most cases of debt restructuring involve a rescheduling (deferral of debt repayment). In contrast, firms infrequently use more drastic measures, some of which could reduce their debt overhang. For the determinants, firms with operating surpluses and negative net worth are more likely to take drastic measures to restructure debt, which is consistent with the debt overhang theory. Firms with operating surpluses are more likely to adopt measures to hold management responsible and to use new outside executives. In terms of performance, firms that use drastic debt restructuring strategies have better gross sales and profits. Firms that use restructuring to hold management more responsible reduce employment and improve profits. These results indicate that firms that use measures to reduce their debt overhang and limit their moral hazard improved their performance.

Keywords: out-of-court debt workouts, debt overhang, moral hazard, zombie firms
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