Can Stricter Bankruptcy Laws Discipline Capital Investment? Evidence from the U.S. Airline Industry

Joe Mazur
Duke University
Job Market Paper
November 2, 2014

Abstract

Models of capital investment in industrial organization typically treat bankruptcy as an involuntary and final outcome, yet firms that file under Chapter 11 of the U.S. Bankruptcy Code typically do so voluntarily and with the expectation that they will eventually emerge. Moreover, Chapter 11 permits cancellation or renegotiation of long-term contracts for labor and capital, effectively providing otherwise constrained firms an opportunity to downsize, and suggesting a non-financial role for bankruptcy law in investment behavior. This paper is the first to analyze the link between bankruptcy and investment in a dynamic oligopoly setting. To capture the strategic implications of both decisions, I develop a dynamic game in continuous time that incorporates choices over investment and bankruptcy. I show that strengthening creditors’ bargaining power in bankruptcy proceedings can discipline capital investment behavior outside of bankruptcy, curbing investment in periods of high demand and spurring the sale of capital when demand is low. I test the implications of the model using data on the bankruptcy-prone U.S. commercial passenger airline industry, finding evidence that a recent reform that strengthened creditors’ bargaining power in Chapter 11 may have contributed to the widely acknowledged “capacity discipline” observed in the market since 2006. I then simulate several alternative bankruptcy policies to better understand how the treatment of contracts in bankruptcy affects long-term investment and industry dynamics.