

Aggregate Implications of Asymmetric Information in Corporate Debt Market and Bankruptcy Law

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Abstract

This paper examines how asymmetric information between creditors and firms affects resource allocation and aggregate productivity under the U.S. corporate bankruptcy law. I develop a heterogeneous firm model in which creditors cannot directly observe a firm's productivity and must rely on indirect signals when offering debt contracts. This informational friction distorts the firm's bankruptcy outcome by affecting whether it undergoes reorganization (Chapter 11) or liquidation (Chapter 7).

Two main distortions emerge in this environment. First, both high- and low-productivity firms face the same debt pricing schedule, resulting in misaligned borrowing costs because creditors cannot perfectly discriminate the debt prices. Second, firms attempt to appear more creditworthy through excessive production, distorting the allocation of capital and labor. Embedding this framework in a general equilibrium setting reveals that the distortions caused by asymmetric information are partially mitigated through endogenous market responses. In particular, wage adjustments and increased firm entry modify firms' behavior in ways that reduce misallocation. Quantitative results show that, although asymmetric information lowers the efficiency of bankruptcy outcomes and depresses total factor productivity, these general equilibrium forces substantially mitigate the aggregate efficiency losses

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