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The Option to Re-organize Firms with Valuable Growth Options and Risky Bond Prices

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ABSTRACT We develop a structural model of corporate bond prices which accounts for the option held by bondholders to liquidate or re-organize a firm that ends up in bankruptcy. Although there is a wide body of literature in corporate finance that examines the trade-offs between liquidation and re-organization for creditors in financially distressed firms, our paper is the first to incorporate these options into the ex-ante value of risky debt. The option to liquidate or to re-organize has value in our model due to the presence of valuable growth options. Liquidation value being the depreciated value of assets in place, ignores the value of these options. But were bondholders to take over control of the firm, the value of the firm is, with some efficiency loss, the sum of the value of assets in place and the value of future growth options.