

COSTS OF FINANCIAL DISTRESS AND INTEREST COVERAGE RATIOS

Michael Dothan

First published: 27 April 2006

<https://doi.org/10.1111/j.1475-6803.2006.00171.x>

I am grateful to Marc Choate, Bruce Gates, Yuyan Lou, Elliot Maltz, Fred Thompson, the participants of the Research Workshop at the Atkinson Graduate School of Management, and the participants of the Finance and Insurance Workshop at Oregon State University for helpful comments. The advice of Thomas H. Noe (reviewer) and William T. Moore (former executive editor) was very helpful in shaping the final version of this article.

Abstract

Creditors routinely impose on a borrowing firm a minimum interest coverage ratio that the firm has to maintain. I show that nonlinear costs of financial distress provide a possible explanation of why firms find it optimal to have an interest coverage ratio covenant in their debt indenture, even in the absence of information asymmetries or agency costs.

References

Private Placement Enhancement Project, 1996, *Financial Covenants Reference Manual* (Cigna Investment Management, Hartford, CT).

[Google Scholar](#)

Crosbie P. and J. Bohn, 2002, *Modeling default risk* (KMV Corporation, San Francisco, CA).

[Google Scholar](#)

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

[Manage Preferences](#)

[Accept All](#)

[Reject Non-Essential](#)

Hamilton D., G. Gupton, and A. Berhault, 2001, Default and recovery rates of corporate bond issuers: 2000, (Moody's Risk Management, New York).

| [Google Scholar](#) |

Kim, J., K. Ramaswamy, and S. Sundaresan, 1993, Does default risk in coupons affect the valuation of corporate bonds? A contingent claims model, *Financial Management* 22, 117-31.

| [Web of Science®](#) | [Google Scholar](#) |

Leland, H., 1994, Corporate debt value, bond covenants, and optimal capital structure, *Journal of Finance* 49, 1213-52.

| [Web of Science®](#) | [Google Scholar](#) |

Leland, H., 1998, Agency costs, risk management, and capital structure, *Journal of Finance* 53, 1213-43.

| [Web of Science®](#) | [Google Scholar](#) |

Taggart, R., 1986. Corporate financing: Too much debt? *Financial Analysts Journal* 42, 35-42.

| [Google Scholar](#) |

Citing Literature



[Download PDF](#)

ABOUT WILEY ONLINE LIBRARY

[Privacy Policy](#)

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

[Manage Preferences](#)

[Accept All](#)

[Reject Non-Essential](#)

OPPORTUNITIES

[Subscription Agents](#)

[Advertisers & Corporate Partners](#)

CONNECT WITH WILEY

[The Wiley Network](#)

[Wiley Press Room](#)

Copyright © 1999-2026 John Wiley & Sons, Inc or related companies. All rights reserved, including rights for text and data mining and training of artificial intelligence technologies or similar technologies.

WILEY

This website utilizes technologies such as cookies to enable essential site functionality, as well as for analytics, personalization, and targeted advertising. You may change your settings at any time or accept the default settings. You may close this banner to continue with only essential cookies. [Privacy Policy](#)

[Manage Preferences](#)

[Accept All](#)

[Reject Non-Essential](#)