THE IMPORTANCE OF DEVIATIONS FROM THE ABSOLUTE PRIORITY RULE IN CHAPTER 11 BANKRUPTCY PROCEEDINGS

by

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The Importance of Deviations from the Absolute Priority Rule In Chapter 11 Bankruptcy Proceedings

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Frequent departures from the absolute priority rule (APR) in Chapter 11 bankruptcy proceedings have been of great interest to financial researchers over the past several years. Since the publication of Franks and Torous (1989), Eberhart, Moore and Roenfeldt (1990) and Weiss (1990) (collectively called the priority papers), many theoretical and empirical papers have explored the implications of departures from the APR.

Recently, Beranek, Boehmer and Smith (1996, hereafter BBS) have questioned the importance and focus of the priority papers. This paper reviews the BBS paper, explains why APR violations have been interesting to finance researchers, and documents the validity of the priority papers' focus.

The BBS paper can be broken down into four parts. First, they claim the priority papers do not inform readers that Chapter 11 allows for violations of the APR. Second, they state the priority papers fail to justify why APR violations are important. Third, they propose a new APR definition. Fourth, they present some empirical evidence to support their views.

The rest of this paper proceeds as follows: Section I documents how the priority papers clearly inform readers of both a creditor's ability to waive her priority rights in Chapter 11 and the importance of APR violations. In Section II we demonstrate the validity of the priority papers' definitions of the APR and the problems with the new definition provided by BBS. Section III uncovers problems and contradictions in the BBS empirical section. Our summary and conclusions are presented in Section IV.

I. Deviations from the APR

A. Full and Complete Disclosure

Eberhart, Moore and Roenfeldt (1990p. 1457) define the APR:

> The absolute priority rule (hereafter APR) states that a bankrupt firm's value is to be distributed to suppliers of capital such that senior creditors are fully satisfied before any distributions are made to junior creditors, and junior creditors are paid in full before common shareholders.

Franks and Torous (1990, p.748) define the APR:

> Absolute priority denies any claimholder a stake in the securities of the reorganized firm, until more senior claims have been fully satisfied.

Weiss (1990, p. 286) defines the APR:

> Priority of claims is violated when senior claimants' are not fully satisfied before junior claimants receive any payment.

BBS refer to these definitions as the "laymen's" APR and argue (p. 102): "the laymen's APR is not current bankruptcy law." However, it is irrelevant whether the priority paper definitions are "current bankruptcy law." As will be fully discussed in Section II, the APR definition used by the priority papers is an important underlying assumption in many finance articles and documenting violations of this rule is a key point of the priority papers. Moreover, as discussion below, the priority papers do provide a clear explanation of the Bankruptcy Code's allowance of APR violations.

BBS claim the priority papers mislead readers by failing to explain the law properly (p. 103): "Note the omission of any references to the power of claimants to waive priority rights and compromise their claims." This is factually incorrect. Franks and Torous (1989) argue that departures from the APR occur because Chapter 11 gives shareholders a right to delay the reorganization process; therefore, creditors agree to violate the APR to resolve the bankruptcy faster. Eberhart, Moore and Roenfeldt (1989) devote an entire section of their paper (Section III.B) to testing the Franks and Torous explanation for why creditors waive their priority rights (they find some support for this explanation). Eberhart, Moore and Roenfeldt clearly state what the law allows (p. 1458): "Reorganization of the corporation is governed by Chapter 11 of this Act, *and this chapter does not generally require that the APR be followed.* (italics

added)" Weiss (1990, p. 290) not only states "the Code allows priority of claims to be violated" but describes how the voting process allows violations and explicitly discusses claimants waiving their rights.

Weiss predicts that deviations from the APR are negatively related to the bargaining power of creditors. In support of this prediction, Betker (1995) finds that APR violations are larger when banks hold fewer claims. Weiss also conjectures that priority violations are larger in the Southern District of New York where larger more complex cases are heard and Betker reports support for this prediction. Eberhart and Senbet (1993) show that these departures reduce the overinvestment problem.

BBS acknowledge the quotation on page 1458 from Eberhart Moore and Roenfeldt shown above (albeit it in a footnote), and (in another footnote) that Franks and Torous point out that creditors may waive their priority rights. Acknowledging these points is problematic for BBS, however, because it calls into question the primary purpose of their paper. They try to get around this problem with the following (p. 105):

> These authors, while implying that creditors may waive priority rights, by asserting that plans must be approved by claimants, nevertheless neglect to advise nonbankruptcy readers that this right is explicitly *mandated* by the Bankruptcy Code.

As explained above, the priority papers do not *imply* that creditors may waive their priority rights—they clearly state it. The failure to state "that this right is explicitly *mandated*," is a meaningless semantic point. The priority papers do not contain a lengthy discussion of the Bankruptcy Code because it is not their focus. They do, however, refer the reader to several different articles for additional details on the Bankruptcy Code. In contrast, BBS not only fail to explain why creditors waive their priority rights,

they also fail to reference the extensive literature in this area.[1] Instead, BBS state (p. 104): "The task of explaining, however, why creditors in general frequently waive their rights in a reorganization is an important issue beyond the scope of this paper."

B. The Importance of Violations to APR

BBS criticize the priority papers for failing to explain why deviations from APR are important[2] They state (p. 105)

> Moreover, if violations of the laymen's APR are legal consequences of the bankruptcy process, these authors fail to disclose why it is important to count the number of violations.

The above quotation is, at best, misleading. For example, Franks and Torous show how the Myers (1977) underinvestment problem—which assumes adherence to the APR—is reduced when there are deviations from the APR. Counting the number of violations is important because if APR violations are rare, the market may not expect these violations and the underinvestment problem will not be reduced.

More generally, the above quotation fails to recognize the prevalence of the APR assumption (as defined by the priority papers) in the finance literature. This rule is explicitly or implicitly assumed in many seminal financial models. In arguably the most important model in finance, Black and Scholes (1973) show that equity can be viewed as a call option on the underlying firm value. The face value of the

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[1]The only exception is a passing reference to the FT explanation of why creditors waive priority rights.

[2]All three studies document regular violations of the "laymen's" APR but each has a different focus. Franks and Torous focus on why creditors agree to deviations from the "laymen's" APR and how these deviations can resolve the underinvestment problem. Eberhart, Moore and Roenfeldt measure the magnitude of "laymen's" APR violations and test the degree to which the capital markets anticipate these violations as of the bankruptcy filing date. Weiss documents the extent of departures both among creditors and between creditors and equity holders in addition to presenting evidence on the direct costs of Chapter 11.

(zero-coupon) debt can be viewed as the stock's exercise price and the debt's maturity as the stock's time to expiration. In this analogy, bankruptcy occurs when the firm value is below the debt's face value and the stock finishes out-of-the-money.

Merton (1974) draws upon the corporate securities as options notion to show how risky debt is the sum of a long position in a risk-free bond and a short position in a put provision on the underlying firm value (where the exercise price equals the face value of the risk-free bond). Both Black and Scholes (1973) and Merton (1974) assume that the APR holds.

The large number of finance articles assuming adherence to the APR, before the publication of the priority papers, is why documented departures from this rule have been of such great interest. Since the publication of the priority papers, many studies have drawn upon their results to investigate the implications of departures from the APR (e.g., Mooradian (1994), Leland (1994)).

II. The Legal View of the APR

A. The BBS Definition of the "laymen's" APR

BBS posit the following definition of the "laymen's" APR (p. 102):

> ... A rule of strict, inflexible priority that mandates that senior creditors—a category that includes secured creditors—be paid in full before junior creditors or equity interests receive any share of a reorganized company.

BBS go on to argue that the priority rules stated in the Bankruptcy Code provide secured creditors with priority over junior creditors only on the value of collateral. If the value of the collateral is less than the allowed claim of the secured creditor, the shortfall is classified as a junior creditor claim. Therefore, the secured claim can be bifurcated into a senior and junior creditor claim. Their use of the term

"laymen's" above is obviously meant to underline their belief in the incomplete nature of the APR as defined by the priority papers.

We disagree with this belief and interpretation of the APR. The APR definitions provided by the priority papers do not mention secured creditors because the role of secured debt has not been of primary interest to financial researchers. The seminal papers by Black and Scholes (1973), Merton (1974), Myers (1977) and many others do not make a distinction between secured and unsecured debt. In fact, as with Black and Scholes (1973), Merton (1974), and Myers (1977), many financial models assume capital structures with equityholders and a single class of creditors.

Consistent with this history, Eberhart, Moore, and Roenfeldt focus on APR violations between *all* creditors and shareholders. Their documentation of departures from the APR appeals to the most basic premise of the rule - all creditors should be paid in full before shareholders receive a payment. With this focus, *the bifurcation of secured claims is irrelevant.* Even if secured creditors have some of their claim relegated to an unsecured claim, they still have priority over the shareholders. Bifurcation does not change the amount owed to all creditors (the issue of post-petition interest is discussed below) and so the documentation of APR violations between shareholders and all creditors is unaffected.

The only way bifurcation can affect the amount owed to *all* creditors is when the amount owed to secured creditors changes as time passes due to post-petition interest (i.e., interest accruing during the bankruptcy). As traditionally defined in the finance literature, the APR does not consider post-petition interest because the seminal models that appeal to this rule treat bankruptcy as an outcome, not the beginning of a potentially lengthy process.

BBS only mention post-petition interest briefly and not in the context of how it may affect the amount owed to all creditors. In contrast, Weiss—who does examine APR violations between secured and unsecured creditors—gives a careful discussion of post-petition interest. As he states (p. 292):

> Bankruptcy law has traditionally been vague about whether secured creditors receive interest on their claims over the bankruptcy period. The Supreme Court has recently clarified this issue in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.* According to an opinion written by Justice Scalia, secured creditors receive interest on their loans at the rate specified up to the value of their secured interest. Once that maximum is reached, no further interest is allowed.

The broad framework of the priority papers' definition of the APR dovetails with the simple capital structure assumed by many seminal models in finance. To criticize it, or studies that use this definition, for not going into the details of the Bankruptcy Code is to miss the point. The definition of the APR used by the priority papers is embedded in the finance literature as an appeal to the payout procedures implicit in the debtor-creditor relationship. As suggested earlier, this is why the priority papers use this definition and why documented departures from this rule are interesting to finance researchers.

<u>B. A Better Definition of the APR?</u>

BBS demonstrate (inadvertently) the pitfalls of trying to convert a general definition of how bankruptcy claims are allocated to a more specific definition. Their alternative to the priority papers' definitions of the APR is their "Legal View of APR." They state that the "Legal View of APR" consists of three elements (p. 104):

> The first of which is essentially the laymen's APR. ... Second, the legal APR is subject to the vital modification that creditors have the power to waive their contractual priority rights. ... Third, the legal APR adds the modification that secured claims, which are senior claims, are subject to bifurcation.

Their definition seeks to expand the definition of the APR to include provisions in the Bankruptcy Code that allow for deviations from the APR. We do not think this definition adds anything to the literature. The first two parts of the definition merely state the traditional definition of the APR with the added fact that creditors may waive enforcement of their priority rights. As noted above, the priority papers have already done this. The last part adds some greater detail on secured debt that, as explained earlier, has not been the focus of most finance-related work.

If the intention of the "Legal View of APR" is to give the reader a full understanding of all the complexities of bankruptcy claim priorities, then BBS have fallen short. For instance, the Bankruptcy Code gives firms some discretion in where they file for Chapter 11. As noted earlier, Weiss argues there is a correlation between the location of the bankruptcy court and the regularity of APR violations. Baird and Jackson (1984) note how some bankruptcy judges, who believe markets usually undervalue bankrupt firms, conduct their own valuations even though their valuations are consistently shown to be significantly inflated. By overvaluing the firm, these judges can appear to be giving senior claimants much more than they are actually receiving. The "Legal View of APR" provides no discussion of this issue.

Moreover, tax laws have an important influence on the distribution of payoffs. Weiss (p. 292) notes the "... Cooperation of the equity holder is essential to maintain the corporate shell and preserve tax-loss carryforwards. Equity holders may receive a distribution of funds from an insolvent firm in return for their cooperation." No discussion of this issue is contained in the "Legal View of APR."

In summary, the "Legal View of APR" is an incomplete description of how claims are divided in Chapter 11. More importantly, it is not the APR assumed by many seminal finance studies and so is of less interest to financial economists.

III. The Empirical Evidence of BBS

Since the publication of the priority papers, new methods of collecting bankruptcy data have become known and those on the frontier of empirical research in this area are obligated to use these new methods. For example, Hotchkiss (1995) undertakes an exhaustive search and constructs a sample of 197 firms emerging from bankruptcy Eberhart, Altman and Aggarwal (1997) conduct an extensive search of firms emerging from bankruptcy with stock trading on the NYSE, AMEX or NASDAQ and build a sample of 131 firms.[3]

BBS gather their sample using dated methods. As a result, their sample consists of only 68 firms. This is a striking shortcoming for a paper claiming achieve (p. 106) "more definitive conclusions" of APR violations by constructing a larger sample.

Notwithstanding their data problems, BBS argue that (p. 106) "... the most direct test of the degree to which strict priority (the "laymen's" APR modified by bifurcation) affects equity interests is to note the number of settlements in which equity receives nothing." This is baffling because it contradicts one of their critiques of the priority papers. On page 105 BBS question why it is important to count the number of violations to APR and then on the very next page they conduct their own count.

BBS find that 33.8% of firms fail to provide for any equity distributions, compared with the previous high of 22% documented by FT. They do not mention the significant difference in the sample

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[3]108 of their firms emerged during the 1986-94 period the BBS sample covers.

periods from that of the priority papers (there is an overlap of only two years) and we think this difference makes the comparison questionable.[4]

BBS conclude, based on finding 33.8% of their cases have no equity distributions, (p. 109) "that a large proportion of reorganizations closely follow a strong form of strict priority." Of course, this still leaves 66.2% of their firms with possible APR violations between all creditors and shareholders. More importantly, despite spending much of the first part of their paper discussing APR violations between senior and junior creditors, they completely ignore this issue in their empirical section. They have not shown how finding that 33.8% of their cases having no equity distribution allows them to conclude anything about APR violations between senior and junior creditors. No serious analysis is provided and the reader is left wondering about the point of the exercise.

IV. Conclusions

Departures from the absolute priority rule (APR) in Chapter 11 bankruptcy proceedings have been of great interest to finance scholars throughout the 1990s. In a recent article appearing in this journal, Beranek, Boehmer and Smith (1996, BBS) criticize three of the early articles in this area (Franks and Torous (1989), Eberhart, Moore and Roenfeldt (1990) and Weiss (1990); collectively called the priority papers), among others. BBS argue that these studies misrepresent the legal aspects of the APR and fail to explain why departures from the APR are of interest. We have shown that their points can be relegated to three categories: false or misleading statements; statements that reveal a misunderstanding of the finance literature; and statements that merely echo points made in the priority papers. We also show that their alternative definition of the APR (the "Legal View of APR") is an arbitrary phrase that provides an

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[4]For example, Betker (1995) identifies some factors that affect APR violations and these surely change over time.

incomplete description of how claims are paid in Chapter 11. Finally, their empirical section is a desultory collection of descriptive statistics and conclusions that contradict earlier points made in their paper.

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