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

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98/27AC/FIN

(Revised Version of 97/90/AC/FIN)

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March 1998

We would like to thank Prem Jain, Lisa Fairchild, and Marilyn Ryngiewicz for their comments and suggestions. Eberhart received support from a Goldman, Sachs & Co. Fellowship and a summer research grant from Georgetown University. The Georgetown University Center for Business-Government Relations also provided support.

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Abstract

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, 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. 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.

Frequent departures from the absolute priority rule (APR) in Chapter 11 bankruptcy proceedings have been of great interest to finance 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.[1]

Recently, Beranek, Boehmer and Smith (1996, hereafter BBS) criticize the priority papers for providing a misleading interpretation of the APR. First, they claim the priority papers do not inform readers that Chapter 11 allows for violations of the APR. Second, they criticize the priority papers for failing to explain why APR violations are important. In the last part of their paper, BBS propose a new APR definition and present some empirical evidence to support their views.

The purpose of this paper is to answer the BBS criticisms and correct any confusions in the literature about APR violations, especially those created by the BBS paper. This paper proceeds as follows: Section I explains the importance of APR violations and documents how the priority papers clearly note that Chapter 11 allows for 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 with the BBS empirical section. Our summary and conclusions are presented in Section IV.

I. Deviations from the APR

A. Full and Complete Disclosure

BBS criticize the APR definition in the priority papers. Listed below are the definitions from each priority paper.

Eberhart, Moore and Roenfeldt (1990 p. 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

[1]For example, Daigle and Maloney (1994), Eberhart and Senbet (1993), Jarrow and Turnbull (1995), Krishnan and Moyer (1994), Leland (1994), Longstaff and Schwartz (1995), Longhofer (1997), Mooradian (1994), Pennacchi and Lewis (1994), Warga and Welch (1993), and many others.

to junior creditors, and junior creditors are paid in full before common shareholders.

Franks and Torous (1989, 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 call these definitions 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 seminal finance articles and documenting violations of this rule is a key point of the priority papers. Moreover, as discussed 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.

All three priority papers, however, clearly note that creditors may waive their priority rights.[2] 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 (1990) devote an entire section of their paper (Section III.B) to testing the Franks and Torous explanation for why creditors waive their priority rights and they find some support for this explanation. Moreover, in the first part of their paper, Eberhart, Moore and Roenfeldt clearly state (p. 1458): "Reorganization of the corporation is governed by Chapter 11

[2]All three studies document regular violations of the APR but each has a different focus. Franks and Torous focus on why creditors agree to deviations from the APR and how these deviations can resolve the underinvestment problem. Eberhart, Moore and Roenfeldt measure the magnitude of 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 besides presenting evidence on the direct costs of 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.

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. Perhaps to overcome the apparent contradiction between their initial claim and their footnote acknowledgments, BBS state (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 fact that they do not 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 and explain why creditors may waive their priority rights. 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.[3] 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 APR Violations

With their title, statements[4], and underlying tone, BBS argue that deviations from the APR definition proposed in the priority papers are unimportant. This argument, however, fails to recognize that

[3]The only exception is a passing reference to the Franks and Torous explanation of why creditors waive priority rights.

[4]For example, BBS state (p. 109) "Without exception, authors did not inform their readers why enumerations of deviation were important."

the APR--as defined by the priority papers--is explicitly or implicitly assumed in many seminal finance models. For instance, Black and Scholes (1973) show that equity can be viewed as a call option on the underlying firm value. The face value of the (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 at maturity and the stock finishes out-of-the-money. The APR is followed because shareholders receive nothing when the bondholders have not been fully paid.

In another study, 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). Myers (1977) shows that shareholders have an incentive to underinvest when the investment gains accrue to the bondholders. Both of these studies also assume that the APR holds. Other examples include Scott (1976), Kim (1978) and many others.

Apparently, BBS are unaware of the prevalence of the ("laymen's") APR definition in the finance literature. This may explain why they criticize the priority papers for failing to explain why deviations from APR are important (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.

Franks and Torous (1989), though, show how the Myers (1977) underinvestment problem 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. As mentioned earlier, since the publication of the priority papers many studies have drawn upon their results to investigate the implications of departures from the APR.[5]

In summary, the APR definition posited in the priority papers is based on the definition assumed in many seminal finance articles. The large number of finance articles assuming adherence to the APR,

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[5]Supra footnote 1.

before the publication of the priority papers, is why documented departures from this rule have been of such great interest.

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 give secured creditors 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 apparently 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 definition provided by the priority papers does not mention secured creditors because the role of secured debt has not been of primary interest to finance 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 many other models, these three 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 any 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 and post-petition interest accrues (i.e., interest accruing during the bankruptcy reorganization period). As traditionally defined in the finance literature (and in the priority papers), however, 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.

B. A Better Definition of the APR?

BBS propose an alternative to the priority papers' definitions of the APR with their "Legal View of APR." This definition 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.

The "Legal View of APR" is an idiosyncratic phrase that provides an incomplete description of how claims are paid in Chapter 11. For instance, the Bankruptcy Code gives firms some discretion in where they file for Chapter 11. Weiss (1990) 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. Tax laws also 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 the issues mentioned above is contained in the "Legal View of APR." Most importantly, because the "Legal View of APR" is not the APR definition used in the finance literature, we think the introduction of this term may create some confusion about the APR definition.

III. The Empirical Evidence of BBS

Notwithstanding certain 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."[6] This is interesting because--as noted earlier--on page 105 BBS question why it is important to count the number of APR violations and then they conduct their own count on the very next page.

BBS find that 33.8% of firms fail to provide for any equity distributions, compared with the previous high of 22% documented by Franks and Torous. They do not mention the significant difference in the sample periods from that of the priority papers (there is an overlap of only two years) and we think this

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[6]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 (1998) 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. The BBS empirical section seeks to achieve (p. 106) "more definitive conclusions" of APR violations by constructing a larger sample but they gather their sample using dated methods. As a result, their sample consists of only 68 firms. The Eberhart, et al. sample period covers a longer period than BBS but 108 of their firms emerge during the period the BBS sample covers.

difference makes the comparison questionable[7]

Based on finding 33.8% of their cases have no equity distributions, BBS conclude (p. 109) "that a large proportion of reorganizations closely follow a strong form of strict priority." This conclusion implies that APR violations are unimportant even though this finding still leaves 66.2% of their firms with possible APR violations between all creditors and shareholders. Moreover, BBS do not attempt to measure the size of APR violations in cases where the rule is not followed (as, e.g., Eberhart, Moore and Roenfeldt do in their measures of the size of APR violations). Finally, despite spending much of the first part of their paper discussing APR violations between senior and junior creditors, BBS ignore this issue in their empirical section.

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 deviations from the APR--as defined in the priority papers--are unimportant and that the Bankruptcy Code does not require adherence to this rule. We show that the APR definition posited in the priority papers is based on the definition assumed in many seminal finance articles and it is deviations from this APR definition that has created so much interest among financial economists. Moreover, the priority papers clearly note that the Bankruptcy Code does not require adherence to the APR.

BBS present an alternative definition of the APR that they call the "Legal View of APR." We demonstrate that this definition is an arbitrary phrase that provides an incomplete description of how claims are paid in Chapter 11.

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

BBS present some empirical evidence to support their views. Their primary conclusion seems to be that APR violations are unimportant. We show that this conclusion is incorrect because most of their sample firms do have possible APR violations; moreover, BBS do not try to measure the size of APR violations and ignore the possibility of APR violations between senior and junior creditors.

In summary, we demonstrate that the priority papers' APR definition is the proper one for financial economists to consider and why APR violations have been interesting to finance researchers. We hope this clarifies the purpose of the priority papers.

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