CONFLICTING PRIORITIES:
A THEORY OF COVENANTS AND COLLATERAL

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FACTS

Firms rely on different types of debt at once

Including secured and unsecured with and without covenants

Secured debt has "absolute priority"

Unsecured debt has covenants limiting new secured debt

Negative pledge covenants common (e.g. 44% in Billett et al 07)

If covenants violated, right to accelerate debt

LAWYERS' VIEW ON N.P. COVENANTS

Negative pledge covenants may be of little practical comfort

The secured party whose presence violates the covenant is entitled to repayment from the collateral before the injured negative pledgee

The covenant does not prevent third parties from acquiring a security interest, but [is] merely...a hollow promise, for in the very act of breaching the covenant, the borrower places its assets out of reach of the negative pledgee

—Bjerre (1999)

In the case of a debtor...indebted to secured creditors acceleration by unsecured creditors...seems somewhat futile

—Hahn (2010)

QUESTIONS

Q1. Why rely so heavily on negative pledge covenants?

Why not just use secured debt to promise priority credibly?

Q2. Why do borrowers use a multi-tiered debt structure?

Why mix secured/unsecured debt with/without covenants?

THIS PAPER

Model of sequential financing based on two frictions

1. Limited pledgeability: can't borrow against projects' full PV
2. Contracts are non-exclusive: can sign conflicting contracts

Role of collateral: establish priority among conflicting contracts

Secured debt has absolute priority over collateral

New secured debt dilutes existing unsecured debt

DILUTION HAS TWO SIDES

Dilution can be bad—can lead to over-investment

New investments subsidized at expense of existing creditors

Dilution can be good—can prevent under-investment

Loosens borrowing constraints due to limited pledgeability

Optimal debt structure allows good dilution, blocks bad dilution

SIMPLIFIED MODEL

BORROWER AND PROJECTS

Borrower B has assets A and debt F_0 in place

Can invest in project that costs $A + I$ with quality $Q \in \{H, L\}$

- Succeeds and pays off $X^Q + Y^Q$ with prob. p; else pays off 0
- X^Q pledgable, Y^Q not

Can liquidate for pX^Q

INSTRUMENTS

Secured debt: promise to repay F^{sec} secured by projects as collateral

Unsecured debt: promise to repay without collateral

Unsecured debt with n.p. covenants: promise without collateral

But option to accelerate if B borrows secured

PRIORITY RULE

Secured debt has priority over collateral

- Ahead of all unsecured debt (absolute priority rule)
- Ahead of later secured debt (first-in-time rule)
- Ahead of any other claimants if collateral liquidated/sold

Unsecured pro-rata in default

- Acceleration gives effective priority over other unsec. debt
- But not over secured debt (protected by collateral)

PARAMETER RESTRICTIONS

PR 1. Project is positive NPV if $Q = H$, negative NPV if $Q = L$

$$p\big(X^H + Y^H\big) > A + I > p\big(X^L + Y^L\big)$$

PR 2. Project is not self-financing

$$pX^Q < A + I$$

FIRST BEST

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Invest iff project has positive NPV

1. B does not invest if $Q = L$

   Problem: non-exclusivity can lead to over-investment

   Borrowing constraints too loose: need to block bad dilution

2. B can invest if $Q = H$

   Problem: limited pledgeability can lead to under-investment

   Borrowing constraints too tight: need good dilution

UNSECURED DEBT

R1: UNSECURED DEBT DOESN'T IMPLEMENT FB

If F_0 unsecured, can dilute: over-investment if $Q = L$

NEGATIVE PLEDGE COVENANTS

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Suppose F_0 unsecured with n.p. covenants

Say B violates covenant, taking secured debt F^{sec} (suff. large)

Creditors have option to accelerate, forcing liquidation

If B anticipates acceleration, won't violate

IS ACCELERATION THREAT CREDIBLE?

Yes, if

$$\underbrace{pX^Q - F^{\text{sec}}}_{\text{acceleration value}} \not> \underbrace{p\big(X^Q - F^{\text{sec}}\big)}_{\text{continuation value}}$$

Acceleration makes secured debt safer (paid first out of liq. value)

Subsidy to secured debt, "tax" on accelerated debt

Don't accelerate to avoid tax

<u>Covenants don't discipline: same outcome as without covenants</u>

What if fraction ϕ of F_0 unsecured with n.p. covenants (rest unsec.)?

$\phi < 1$: IS ACCELERATION THREAT CREDIBLE?

Yes, if

$$\underbrace{pX^Q - F^{\text{sec}}}_{\text{acceleration value}} > \underbrace{\phi p\big(X^Q - F^{\text{sec}}\big)}_{\text{continuation value}}$$

Acceleration is credible if ϕ is low

Acceleration doesn't undo harm of dilution with secured debt

But dilutes other unsecured debt $(1 - \phi)$

<u>Yet another side of dilution: to make acceleration credible</u>

If credible at the right time could lead to efficient investment

R2: COVENANTS IMPLEMENT FB IF $X^H < X^L$

If good dilution large relative to bad, can find ϕ to implement FB

1. Don't invest if $Q = L$: covenant upheld, deterring dilution

2. Invest if $Q = H$: covenant waived, allowing dilution

WHY NOT SECURED DEBT?

Collateral overhang (Donaldson–Gromb–Piacentino 19)

Secured debt prevents good dilution

Can implement efficiency with secured if $X^H > X^L$

Complement of when covenants work

RESULTS MATTER FOR POLICY

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Lawyers advocate relaxing absolute priority of secured debt

> *This article challenges the desirability of...full priority of secured claims*
>
> —Bebchuk–Fried (1996)

Such proposals protect against dilution, but maybe too much

We show existing priority rules efficient if right mix of debt

RESULTS RESONATE WITH PRACTICE

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Explain why negative pledge covenants pervasive

Billet et al 07, Ivashina–Vallée 18

Explain why covenants frequently violated

Chava–Roberts 08, Dichev–Skinner 02, Roberts–Sufi 09

Explain why covenants typically waived following violations

Beneish–Press 93/95, Gopalakrishnan–Parkash 95, Sweeney 94

Explain why covenant use increases in growth opportunities

Billet–King–Mauer 07

Explain why distressed firms use secured debt

Badoer et al. 17, Barclay–Smith 95, Rauh–Sufi 10

QUESTIONS

Q1. Why use negative pledge covenants instead of secured debt?

Q2. Why do borrowers use a multi-tiered debt structure instead?

ANSWERS

Q1. Why use negative pledge covenants instead of secured debt?

A1. Secured debt can protect too much against dilution

Q2. Why do borrowers use a multi-tiered debt structure instead?

A2. Allows good dilution and prevents bad dilution

CONCLUSIONS

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Covenants can be violated and contracts can conflict

- Need priority rule to resolve conflicts

Lawyers argue current priority rule is perverse

But we show it helps implement efficiency via right debt structure

- Debt structure is multi-tiered—rich and realistic

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APPENDIX

APR VIOLATIONS

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Important for mechanism that secured debt is paid first

- Secured debt must dilute existing unsecured debt

Papers on APR violations (e.g. Bris–Welch–Zhu 06)

- No violations in Ch. 7
- 11% in Ch. 11: unsec. paid in part before sec. paid in full

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ACCELERATION PAYOFFS

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Assumed accelerated debt paid before long-term unsecured debt

Pay accelerated debt till run out of cash (sequential service)

Nothing left pay other unsecured debt when finally default

Alternatively: accelerate partially

Get maximum repayment without triggering default

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PREFERENTIAL TRANSFER

In practice, risk that payments before default could be clawed back

If acc. triggers default, risk deemed “preferential transfer”

Using partial acceleration not to trigger default avoids this risk

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PREFERENTIAL TRANSFER

In practice, risk that payments before default could be clawed back

If acc. triggers default, risk deemed “preferential transfers”

Using partial acceleration not to trigger default avoids this risk

Anyway, noise in acceleration payments doesn’t affect results

Just need accelerated debt paid more than other unsec. debt

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PREFERENTIAL TRANSFER HARD TO SHOW

The law concerning preferences and the defense of preference lawsuits is some of the most complicated and convoluted in all of bankruptcy...

Requires creditor receive more than she would in bankruptcy

And transfer must be made

1. to or for the benefit of a creditor
2. for a debt that owed before the transfer was made
3. while the debtor was insolvent
4. within 90 days of the bankruptcy filing

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