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## Prepacks

### An empirical analysis of prepackaged bankruptcies

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#### Abstract

We provide comprehensive data on the attributes and outcomes of the restructuring process for a sample of 49 financially distressed firms that restructured by means of a prepackaged bankruptcy. Our findings complement previous research on out-of-court restructurings and traditional Chapter 11 filings. By most measures, including the time spent in reorganization, the direct fees as a percent of pre-distress assets, the recovery rates by creditors, and the incidence of violations of absolute priority of claimholders, we find that prepacks lie between out-of-court restructurings and traditional Chapter 11 bankruptcies.

*Key words:* Financial distress; Bankruptcy; Prepacks

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#### 1. Introduction

A prepackaged bankruptcy (prepack) is often viewed as a hybrid form of corporate reorganization combining some of the features of an out-of-court restructuring with some of the features of a traditional Chapter 11

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reorganization.<sup>1</sup> As in an out-of-court restructuring, the creditors and the debtor negotiate the terms of the reorganization outside of court. As in a traditional Chapter 11, a bankruptcy petition and a plan of reorganization must be filed and ratified by the court before the prepack becomes effective. This paper documents the attributes and outcomes of the restructuring process for 49 financially distressed firms that reorganized by means of a prepack.

Prepacks are a recent, albeit growing, mechanism for restructuring financially distressed firms. Crystal Oil, with assets of \$342 million, filed a prepack in 1986 and is customarily identified as the first major firm to do so.<sup>2</sup> Our search of various data bases identifies the next prepack as occurring in 1988, with assets of \$48 million, and two more in 1989 with combined assets of \$1.7 billion. During the first six months of 1993 alone (which encompasses the end of our sample period), 12 prepacks were filed by firms with combined assets exceeding \$5.5 billion. According to New Generation Research, Inc., a research firm which follows companies in bankruptcy, default, or financial distress, 22 of the 41 public firms with assets exceeding \$100 million that filed for Chapter 11 in 1993 filed a prepack.

Investigations of alternative procedures for reorganizing financially distressed firms are motivated, at least in part, by concerns that an inefficient bankruptcy reorganization procedure can lead to the dissipation of corporate resources or to the inefficient allocation of capital both before and after the firms become financially distressed.<sup>3</sup> The most efficient reorganization procedure is the one that creates (or preserves) the greatest value net of all costs. Unfortunately, efficiency cannot be observed directly. However, a number of indirect measures of efficiency, such as the length of time required to reorganize, the direct fees associated with the reorganization, the degree to which absolute priority is violated, and recovery rates by creditors, are observable.

Eberhart, Moore, and Roenfeldt (1990), Franks and Torous (1989, 1994), Gilson, John, and Lang (1990), Gilson (1990), and Weiss (1990) present comprehensive evidence on the attributes and outcomes of the restructuring process for samples of financially distressed firms that restructured by means of out-of-court reorganizations and traditional Chapter 11 bankruptcy procedures. This study is designed to complement previous research by providing similar comprehensive

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<sup>1</sup>See for example, McConnell and Servaes (1991), Chatterjee, Dhillon, and Ramirez (1993), and Altman (1993).

<sup>2</sup>Lawyers with whom we have spoken believe that prepacks may have been used by smaller firms prior to 1986.

<sup>3</sup>Analyses of the efficiency of the Chapter 11 reorganization process and of the implications of Chapter 11 for the allocation of corporate assets have been undertaken by Bebchuk (1995), Berkovitch and Israel (1991), Bradley and Rosenzweig (1992), Brown (1989), Easterbrook (1990), Gertner and Scharfstein (1991), Mooradian (1994), and Wruck (1990), among others.

data on prepacks. On most measures considered, prepacks lie between out-of-court restructurings and traditional Chapter 11 reorganizations. Accordingly, it is tempting to conclude that a prepack is a more efficient mechanism for resolving financial distress than a traditional Chapter 11 reorganization, but less efficient than an out-of-court restructuring. Unfortunately, because the firms in our sample have chosen to reorganize by means of a prepack (presumably because that represents the most efficient form of reorganization for the firm), that conclusion is unwarranted. Thus, our study, like those that precede it, is unable to resolve the question of whether one form of reorganization is more efficient than another. Nevertheless, the evidence we present can contribute to a more informed discussion.

The following section describes certain features of out-of-court restructurings, traditional Chapter 11 reorganizations, and prepackaged bankruptcy proceedings. Section 3 identifies the sources used to assemble our sample and provides some descriptive statistics for the firms in the sample. Section 4 presents data on the frequency with which the first and subsequent prepackaged plans of reorganization were confirmed, the time spent in bankruptcy, the time spent negotiating with creditors prior to filing a prepack, direct fees incurred in the prepack, payoffs to creditors, the degree to which absolute priority is violated, and the allocation of post-bankruptcy stock ownership. Section 4 also presents an event study of stock returns around the initial restructuring announcements, the bankruptcy filing dates, and the dates the restructurings are completed. Section 5 considers related issues and Section 6 concludes.

## **2. The prepackaged bankruptcy procedure**

An out-of-court restructuring typically attempts to reduce the debt burden of the financially distressed firm through a voluntary exchange of debt securities, a tender offer for publicly traded debt, or a voluntary restatement of the terms of privately held debt such as bank or insurance company loans. These transactions do not require court approval for implementation. Because these restructurings are voluntary, creditors are not required to participate in the reorganization. Creditors who do not participate retain their original claims against the firm. The voluntary nature of out-of-court restructurings does not mean that debtors are without means to coerce creditors into participating in the reorganization. One form of coercion is the implied threat of a potentially lengthy and costly traditional Chapter 11 filing if the out-of-court reorganization fails.

With a traditional Chapter 11, either the debtor or, less commonly, a creditor of a financially distressed firm files a bankruptcy petition. The debtor then receives an 'automatic stay' and has the exclusive right to propose a plan of reorganization within 120 days following the filing date. The debtor need not

consult with creditors in developing the plan and, customarily, the court grants several extensions to the 120-day exclusive period. Once a plan is filed, the court determines whether the debtor has made adequate disclosure for claimholders to assess the merits of the plan. If so, a vote on the plan is taken.

For voting purposes, claimholders are grouped into classes based on the type of claim and the treatment of the claim under the plan. Confirmation of the plan requires approval by two-thirds in amount and more than one-half in number by each class of claimholder. Unless the court determines that disclosure is inadequate or that proper voting procedures were not followed, the vote is binding on all participants. If the plan is not supported by an adequate fraction of claimholders, the court can 'cram down' the plan on dissenting participants. In a Chapter 11, all claimholders must exchange their old securities in accordance with the terms of the plan.

The primary procedural difference between a prepack and a traditional Chapter 11 is that with a prepack the bankruptcy petition and the plan of reorganization are filed concurrently. The vote on the prepack may take place either before or after the plan is filed. We term the former as 'pre-voted' and the latter as 'post-voted' prepacks. As nearly as we can determine, post-voted prepacks have always been permitted. However, the Bankruptcy Reform Act of 1978 made specific provision for pre-voted prepacks. Prior to the 1978 Act, bankruptcy law required that any vote on a bankruptcy reorganization take place under the auspices of the court. The 1978 Act specifically allowed for a vote to be taken prior to the Chapter 11 filing. As with any other bankruptcy reorganization, confirmation of the plan requires approval by two-thirds in amount and more than 50% in number by each class of claimholder. In a pre-voted prepack, the outcome of the vote is filed along with the bankruptcy petition and the plan of reorganization and, unless the court determines that inadequate disclosure was made or that the voting was improperly conducted, the vote is binding on all claimholders. The primary procedural difference between pre-voted and post-voted prepacks is that with post-voted prepacks, the vote is conducted under the auspices of the Bankruptcy Court after the firm enters Chapter 11.<sup>4</sup>

Thus, prepacks are similar to traditional Chapter 11 filings in that the reorganization occurs under the auspices of the court and all claimholders must participate in any exchange of securities. They are similar to out-of-court restructurings in that the creditors and the debtor have the opportunity to agree to the terms of the restructuring outside of court. It is these similarities that give rise to the notion of the prepack as a hybrid form of reorganization. In the data

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<sup>4</sup>A second procedural difference is that securities issued as part of a pre-voted prepack are subject to SEC registration requirements, while securities issued in a post-voted prepack are not.

analyses that follow, we compare various statistics for prepackaged bankruptcies with those for out-of-court reorganizations and traditional Chapter 11 restructurings as presented in other studies. Furthermore, within this investigation, we separately tabulate data for pre-voted and post-voted prepacks to determine whether the outcomes of the two procedures differ systematically from each other.

### 3. Sample selection

To identify our sample of prepacks, we conduct a key word search on 'prepack', 'prepackaged bankruptcy', and 'prearranged bankruptcy' for the period January 1980 through June 1993. We use four data sources: the Lexis Conews File, the *National Newspaper Index*, the *National Magazine Index*, and the *Bankruptcy DataSource*. The Lexis Conews File includes newswire coverage of press releases by firms, credit rating agencies, securities exchanges, and governmental agencies. The *Bankruptcy DataSource* is produced by New Generation Research, Inc. (NGR). This search identified 84 firms as candidates for our prepack sample. Four of these firms restructured out of court and seven filed a traditional Chapter 11 prior to June 30, 1993. For an additional 13, we found no indication that the firm had reorganized outside of court or filed a Chapter 11 before June 30, 1993. Thus, we identified 60 firms that filed prepacks during our sample period. Of these 60, we delete 11 because we are unable to obtain the plans of reorganization containing data required for our analyses. Of our final sample of 49 prepacks, one firm (the aforementioned Crystal Oil Company) filed in 1986, two firms filed prepacks in 1989, four in 1990, 13 in 1991, 17 in 1992, and 12 in the first six months of 1993.

We do not require that the firms have publicly traded stock or bonds to enter the sample. However, of the 49 firms in the sample, 44 had at least one publicly traded security and 23 had publicly traded common stock. The largest firm in the sample, Southland Corp., had total assets of \$3.4 billion, but did not have publicly traded common stock. The smallest firm, ARIX Corp., had assets of \$9.7 million and did have publicly traded common stock. The mean and median book value of total assets for the firms in the sample at the end of the fiscal year prior to the Chapter 11 filing are \$570 million and \$313 million, respectively. Thus, the relative frequency of firms with privately held stock in our sample is not so much attributable to the size of the firms, but to the fact that 22 of the firms underwent a leveraged buyout (LBO) within the seven-year period prior to filing the prepack. Our sample of 49 firms includes 32 firms that filed pre-voted prepacks and 17 that filed post-voted prepacks. On average, firms that filed pre-voted prepacks are larger than those that filed post-voted prepacks; the mean book value of the assets of the two groups are \$642 million and \$428 million, with medians of \$335 million and \$167 million, respectively. Appendix A

gives a complete list of the firms along with their Chapter 11 filing dates, and the total assets of each firm, and also indicates whether the firm had publicly traded securities, whether the firm filed a pre-voted or post-voted prepack, and whether the firm underwent an LBO during the seven years prior to the prepack.

#### **4. Data analysis and results**

One preliminary measure of whether the prepackaged bankruptcy process is likely to represent an efficient mechanism for reorganizing financially distressed firms is whether firms that file prepacks successfully reorganize and emerge from Chapter 11. A second preliminary measure is whether the first plan of reorganization filed with the Chapter 11 petition is confirmed by the court. In our sample, all 49 firms eventually reorganized and emerged from Chapter 11. In 38 cases, the initial plan of reorganization was confirmed, in nine cases a second plan was confirmed, in one case a third plan was confirmed, and in the final case, a fourth plan was confirmed.

As might be expected, the initial plan was confirmed in a higher percentage of pre-voted than post-voted prepacks. In 30 of the 32 pre-voted prepacks, the initial plan was confirmed by the court. In the other two cases (Southland Corp. which filed in 1990 and Sunshine Metals which filed in 1992) sufficient votes were cast in favor of the first plan to achieve confirmation, but the court ruled that the voting procedure was improper and disallowed the vote. In both cases, before a re-vote was taken on the initial plan, the debtor and creditors renegotiated the plan of reorganization and these slightly modified plans were confirmed.

Of the 17 post-voted prepacks, the first plan was confirmed in eight and a second or subsequent plan was confirmed in nine cases. As with pre-voted prepacks, the modifications to the initial plans were modest. In two of the nine cases, the only change to the original plan was the 'minor modification' of a bank credit agreement; there were no changes to the principal amounts of the loans. In six of the remaining seven cases, at least one class of nonbank creditors received additional securities or cash, or received debt securities with improved terms. In the final case, the firm paid the fee of the financial advisor to the noteholders' committee. A detailed description of the changes to the initial plans of reorganization is contained in Appendix B.

In sum, in a substantial fraction of prepacks, the initial plan of reorganization filed with the bankruptcy petition is confirmed. In those cases in which the initial plans are not confirmed, the modifications to the initial plan are modest. Based on our preliminary analysis, it is likely that prepacks lead to a reduction in time spent in court relative to a traditional Chapter 11 and to a reduction in the associated expenses. It is to an examination of these statistics that we turn next.

#### 4.1. Time elapsed in reorganization

To compile information on the length of time required for firms to reorganize by means of a prepack, we search the Lexis Conews File, the *Bankruptcy DataSource*, the *Wall Street Journal Index*, and the *National Newspaper Index* for each firm to identify its Chapter 11 filing date and the bankruptcy confirmation date. For each firm, we then search these data sources beginning five years prior to the filing date up through the filing date to identify an initial indication of a restructuring attempt. Because some firms successfully restructure and then become financially distressed again, we use the first reported attempt at restructuring prior to the prepack filing, but after any previously completed out-of-court reorganization, as the starting date of the restructuring process that leads to the prepack. For 43 firms, we identify at least one attempt to restructure prior to filing a prepack. For the remaining six firms, we assume that the restructuring begins on the date of the first default on a liability prior to the prepack filing date.<sup>5</sup> This procedure follows Gilson, John, and Lang (1990) as a way of identifying the beginning of the restructuring attempt.

Table 1 provides summary statistics on the time between the date of the announcement of the initial restructuring attempt and the filing date of the prepack, the total time in bankruptcy (measured as the number of months between the filing date and the confirmation date), and the total time in restructuring (measured as the number of months between the initial restructuring attempt and the confirmation date). As shown in panel A, debtors spent an average of 18.3 months negotiating with creditors prior to filing a prepack and more time was devoted to negotiating pre-voted than post-voted prepacks (means = 20.0 months and 14.9 months, respectively). Additionally, as shown in panel B, pre-voted prepacks averaged less time in Chapter 11 than did post-voted prepacks (1.9 months versus 6.0 months). Apparently, firms that undergo a pre-voted prepack substitute time negotiating out of court for time spent in Chapter 11 relative to firms that undergo a post-voted prepack. Indeed, as reported in panel C, even though pre-voted prepacks spent less time in Chapter 11 than did post-voted prepacks, from start to finish of the entire reorganization process, the total time of 21.9 months required by pre-voted prepacks was slightly greater than the total of 20.9 months required on average for post-voted

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<sup>5</sup>The two most common types of initial restructuring announcements are that the firm is negotiating with creditors to restructure the debt (18 cases) and that the firm has renegotiated a covenant in a debt contract (8 cases). At some time prior to filing the prepack, 46 of the firms defaulted on at least one liability. By far, the vast majority of the defaults (32 cases) are failure to make payment of a liability. It is likely, however, that many of these defaults were preceded by technical defaults that are not recorded by our data sources. Of the three firms that had not defaulted, one had negotiated forbearance agreements with creditors, and two were in imminent danger of default.

Table 1

Time elapsed in various phases of reorganizations for 49 firms that filed prepackaged bankruptcies over the period October 1986 through June 1993 and comparable data for other types of reorganization as presented in other studies.

The initial restructuring announcement is the first reported attempt at restructuring prior to the prepack filing, but after any previously completed restructuring attempt. The date of the resolution of financial distress for prepacks is the Chapter 11 confirmation date.

Sample	Mean	Med	Min.	Max.	No. of firms
<i>Panel A. Time from initial restructuring announcement to Chapter 11 filing (in months)</i>					
All prepacks	18.3	18.1	1.4	47.8	49
Pre-voted prepacks	20.0	18.9	5.7	47.8	32
Post-voted prepacks	14.9	14.4	1.4	33.5	17
Traditional Chapter 11s (Gilson et al.)	8.1	3.0	1.0	42.0	89
<i>Panel B. Time from Chapter 11 filing date to confirmation date (in months)</i>					
All prepacks	3.3	2.1	1.0	15.5	49
Pre-voted prepacks	1.9	1.4	1.0	5.6	32
Post-voted prepacks	6.0	4.3	2.4	15.5	17
Traditional Chapter 11s (Gilson et al.)	20.4	18.0	3.0	43.0	89
Traditional Chapter 11s (Weiss)	30	Not reported	8	99.6	37
<i>Panel C. Time from initial restructuring announcement to resolution of financial distress (in months)</i>					
All prepacks	21.6	21.4	3.8	49.7	49
Pre-voted prepacks	21.9	21.7	7.2	49.7	32
Post-voted prepacks	20.9	18.8	3.8	49.1	17
Out-of-court restructurings (Gilson et al.)	15.4	11.0	1.0	72.0	80
Traditional Chapter 11s (Gilson et al.)	28.5	Not reported			89

prepacks. Based on a Wilcoxon rank sum test, the time spent in out-of-court negotiations is marginally significantly greater for post-voted prepacks ( $z$ -statistic = 1.68). The time spent in Chapter 11 is significantly shorter for pre-voted prepacks ( $z$ -statistic =  $-4.49$ ), and the total time in restructuring is indistinguishable between the two types of prepacks ( $z$ -statistic = 0.65).

For comparison purposes, Table 1 also gives summary statistics for the time required to reorganize out of court and by means of a traditional Chapter 11 as reported by Gilson et al. (1990) and Weiss (1990). Four conclusions follow from these comparisons: (1) the length of time spent negotiating prior to filing for bankruptcy is substantially longer for prepacks than for traditional Chapter 11 filings (panel A); (2) the length of time spent in court is substantially

less for prepacks than for traditional Chapter 11 reorganizations (panel B); (3) apparently, firms that file prepacks substitute time negotiating out of court for time spent in Chapter 11 reorganizations. However, the substitution is not one-for-one, as the total time required to complete a prepack is somewhat closer to, but still dramatically less than, the time required to complete a traditional Chapter 11 reorganization (panel C); and (4) the total time required to complete a prepack lies near the midpoint between the length of time required to complete an out-of-court restructuring and a traditional Chapter 11 reorganization (panel C).

#### 4.2. Direct fees

We now consider the direct fees associated with restructuring by means of a prepack. For 39 of the 49 firms in our sample, we are able to obtain data on the direct costs associated with the financial restructuring from disclosure statements or from the 10-Ks or 10-Qs that followed the firm's emergence from Chapter 11. Our definition of direct fees, which includes court costs and professional fees, corresponds as closely as possible to Weiss's (1990).<sup>6</sup> The bulk of the fees go to financial advisors. Other elements of the direct restructuring costs are professional fees paid to lawyers and accountants, and the relatively modest expenses associated with mailing and printing the disclosure statements and ballots. Frequently, the debtor bears the legal and accounting fees incurred by the creditors' committees.

In our sample, the total direct costs of restructuring range from \$112,000 to \$55,000,000 with a mean of \$7,050,000. As shown in panel A of Table 2, costs as a fraction of the book value of assets range from 0.33% to 12.74%, with an average of 1.85%, where assets are measured as of the fiscal year-end prior to the Chapter 11 filing. As a fraction of assets, the fees paid in prepacks lie between the average of 2.8% reported by Weiss (1990) for traditional Chapter 11 reorganizations and the 0.65% reported by Gilson et al. (1990) for out-of-court restructurings. Also, as shown in panel A, the average direct costs as a fraction of assets are modestly lower for pre-voted prepacks (1.65%) than for post-voted prepacks (2.31%). Based on the Wilcoxon rank sum test, the difference between pre- and post-voted prepacks is not statistically significant ( $z$ -statistic = 0.40). These data indicate that the direct costs of reorganizing by prepacks generally, as well as by both pre-voted and post-voted prepacks, lie between those of out-of-court restructurings and traditional Chapter 11 reorganizations.

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<sup>6</sup>We thank Larry Weiss for discussing his method for collecting fee data with us. Weiss's data come directly from court records and, therefore, are presumably more accurate than are ours.

### 4.3. Distributions in prepackaged reorganizations

Examination of payoffs to claimholders is another way to evaluate alternative mechanisms for restructuring financially distressed firms. Payoffs to claimholders are a concern for at least three (interrelated) reasons. The first has to do with the distribution of wealth among claimholders, the second with whether absolute priority is upheld among claimholders, and the third with whether control of voting rights (and, therefore, control of the firm) is retained by 'old' shareholders or is transferred to creditors. Each of these concerns focuses on

Table 2

Direct costs of restructuring, percentage recovery rates for creditors and preferred stockholders, and percentage dollar deviations from absolute priority for 49 prepacks over the period October 1986 through June 1992

#### Panel A. Direct restructuring fees as a percentage of the book value of assets for 39 of 49 prepacks

Sample	Mean	Med.	Min.	Max.	No. of firms
All prepacks	1.85%	1.45%	0.33%	12.74%	39
Pre-voted prepacks	1.65	1.52	0.33	3.65	27
Post-voted prepacks	2.31	1.40	0.68	12.74	12
Traditional Chapter 11s (Weiss)	2.8	2.5	0.9	7.0	31
Out-of-court restructurings (Gilson et al.)	0.65	0.32	0.01	3.40	18

Our definition of direct fees corresponds as closely as possible to Weiss (1990) and includes court costs and professional fees. An estimate of the fees paid by each firm is obtained from the disclosure statements or from the 10-K or 10-Q statement following the firm's emergence from Chapter 11. Direct assets are taken from the financial statements at the fiscal year-end preceding the Chapter 11 filing. Ten prepacks are excluded in this panel because we are unable to obtain estimates of the fees.

#### Panel B. Average percentage recovery rates for creditors and preferred shareholders for 41 of 49 prepacks

Sample	Type of claim or security (number of firms with one or more classes of claimholders in that category in parentheses)					
	Unclassified claims	Priority claims	Secured creditors	Unsecured creditors	Preferred stock	Entire firm
All prepacks	100.0% (41)	100.0% (41)	99.3% (36)	64.0% (41)	15.9% (14)	72.9% (41)
Pre-voted prepacks	100.0 (26)	100.0 (26)	100.9* (25)	65.3 (26)	19.1 (11)	75.1 (26)
Post-voted prepacks	100.0 (15)	100.0 (15)	95.8 (11)	61.9 (15)	4.1 (3)	69.2 (15)

Table 2 (continued)

Sample	Type of claim or security (number of firms with one or more classes of claimholders in that category in parentheses)					
	Unclassified claims	Priority claims	Secured creditors	Unsecured creditors	Preferred stock	Entire firm
Out-of-court restructurings (Franks and Torous, 1994)			Not reported			80.1 (45)
Traditional Chapter 11s (Franks and Torous, 1994)			Not reported			50.9 (37)

The percentage recovery rate for a class of claimholders is the payoff to the class divided by the face amount of claims for that class. The face value of the claims for each class of claimholders is taken from the firm's plan of reorganization. To determine the payoff to a class of claimholders, we sum the amount paid in cash, the amount paid in new debt securities (at face value), the amount paid in preferred stock (at face value), and the amount paid in common stock (at estimated market value). The amount of cash, the face amount of debt and preferred stock, and the number of shares of common stock are taken from the disclosure statement. In 30 cases, the closing price of common stock on the first day for which prices are available following the firm's emergence from bankruptcy is used to estimate the value of common stock. In an additional eight cases where common stock prices are unavailable, we use an estimate of the fair market value of common stock from the disclosure statement. Eight prepacks are omitted from this panel. In these firms, at least one class of creditors or preferred shareholders received equity for which we could not obtain an estimated market value.

\*In our sample, recovery rates exceeding 100% arise when creditors receive equity which, ex post, trades at a sufficiently high price that the total value of cash and securities received is greater than the value of the original claim.

*Panel C. Average percentage dollar deviations from absolute priority by category of claimholder for 38 of 49 prepacks*

Sample	Type of claim or security (number of firms with at least one class of claimholders in that category in parentheses)					
	Unclassified claims	Priority claims	Secured creditors	Unsecured creditors	Preferred stock	Common stock
All prepacks	0% (38)	0% (38)	- 0.61% (33)	- 1.42% (38)	0.69% (13)	1.71% (38)
Pre-voted prepacks	0 (24)	0 (24)	- 0.91 (23)	- 1.91 (24)	0.47 (10)	2.59 (24)
Post-voted prepacks	0 (14)	0 (14)	0.09 (10)	- 0.57 (14)	1.44 (3)	0.20 (14)

The average percentage dollar deviation is the dollar deviation from absolute priority by a category of claimholders divided by the total value received by all claimholders for a firm. The product of the average percentage deviation and the number of firms with claimholders in a particular category summed across all classes of claimholders is zero. Eleven prepacks for which we could not obtain an estimated market value of equity are omitted from this panel.

a different aspect of the way in which the bankruptcy process influences the allocation of capital.

The distribution (or redistribution) of wealth is of interest because of the implications for the pricing of financial claims (e.g., Brennan and Schwartz, 1980).<sup>7</sup> The enforcement of absolute priority has implications for the reliability of contracts. If absolute priority is violated, the contractual agreements represented by financial claims become unreliable. To the extent that financial contracts are designed to assure the efficient allocation of capital, for example by minimizing monitoring costs, abrogation of financial contracts by the Bankruptcy Court increases the cost of raising capital (e.g., Jensen, 1989, 1991). The degree to which control is transferred from shareholders to creditors also has implications for corporate investment policy. If the bankruptcy process impedes the transfer of control, corporate managers may be led to 'over-' or 'under-invest' (e.g., Zender, 1991). To address these issues for prepacks, we examine the recovery rates of creditors and preferred stockholders, the frequency with which absolute priority is violated, the percentage dollar deviations from absolute priority, and the allocation of share ownership that results from the reorganization.

#### 4.3.1. *Recovery rates*

The Bankruptcy Reform Act of 1978 groups claimholders into six categories: unclassified claims, priority claims, secured claims, unsecured claims, preferred stockholders, and common stockholders.<sup>8</sup> Because common shareholders do not have a dollar claim against the firm, we cannot calculate their recovery rate (i.e., the fraction of claims paid). To determine the recovery rate for the other classes of claimholders, we divide the payoff to the class by the face value of claims for that class. The face value of the claims is taken from the firm's plan of reorganization. Ideally, in determining the value of payoffs, we would employ the market values of securities distributed plus cash. Because the market values of securities distributed are not available in all cases, we use a combination of book and market values. To determine the payoff to a class of claimholders, we sum the amount paid in cash, the amount paid in new debt securities (at face value), the amount paid in preferred stock (at face value), and the amount paid in

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<sup>7</sup>The abrogation of absolute priority will always affect the pricing of financial claims, but does not necessarily increase the firm's cost of capital. That is, so long as the 'rules of the game' are known, the claims will be priced fairly even if absolute priority is violated. It is only when the rules of the game are discretionary that abrogation of absolute priority can increase the firm's cost of raising capital.

<sup>8</sup>Unclassified claims consist of administrative costs including legal fees, financial advisory fees, and the general cost of running the firm in bankruptcy, and priority tax claims. Priority tax claims are taxes incurred by the firm prior to filing for bankruptcy. Priority claims (other than taxes) are employee-related and are paid in full before any other class of creditors.

common stock (at estimated market value). The amount of cash, the face amount of debt and preferred stock, and the number of shares of common stock are taken from the disclosure statement. In 30 cases, the closing price of the common stock on the first day for which prices are available following the firm's emergence from bankruptcy is used to estimate the value of common stock. In an additional eight cases, we use an estimate of 'fair' market value from the disclosure statement. In the remaining 11 cases, we are unable to obtain any estimate of the market value of equity.

The subsample of firms for which we are able to calculate recovery rates for creditors and preferred stockholders includes the 38 firms for which we can obtain an estimate of the market value of the common stock and an additional three firms whose creditors and preferred stockholders did not receive common stock. Panel B of Table 2 gives the average recovery rate for each category of creditors, for preferred stockholders, and for creditors and preferred stockholders combined – referred to by Franks and Torous (1994) as the recovery rate of the firm. Unclassified and priority claimholders recover 100% of their claims in each case in our sample. As shown in panel B, the average recovery rate for secured creditors is 99.3%, the average recovery rate for unsecured creditors is 64.0%, and the average recovery rate for preferred stockholders is 15.9%. The average overall recovery rate for all the firms in the sample is 72.9%. For pre-voted prepacks, the average overall recovery rate of 75.1% is slightly, but not statistically significantly, greater than the overall recovery rate of 69.2% for post-voted prepacks (Wilcoxon rank sum test  $z$ -statistic = 0.32). To the extent that there is a difference between pre- and post-voted prepacks, it is that creditors fare slightly better in pre-voted than in post-voted prepacks. Additionally, the average overall recovery rate for prepacks, as well as the average recovery rates for both pre- and post-voted prepacks, lies between the average overall recovery rate of 80.1% for out-of-court restructurings and the average overall recovery rate of 50.9% for traditional Chapter 11 reorganizations as reported by Franks and Torous (1994).

#### *4.3.2. Frequency of deviations from absolute priority*

We now turn to the question of whether absolute priority is upheld to a greater or lesser extent in prepacks than in traditional Chapter 11 reorganizations. Absolute priority is upheld when a class of securities receives a payoff whose market value is at least equal to the face value of its claim before any class junior to it receives any distribution. To determine the degree to which priority is upheld in our sample, we follow the classification developed by Weiss (1990). We classify each firm into one of three categories. We classify a firm as upholding absolute priority if secured creditors are paid in full before junior claimholders receive any distribution and if stockholders receive no distribution until secured and unsecured creditors are paid in full. A firm is classified as violating priority for unsecured creditors if secured creditors are paid in full

before junior claimholders, but one or more classes of unsecured creditors do not receive full payment before stockholders receive a distribution. Finally, we classify a reorganization as violating priority for secured creditors if at least one class of secured creditors receives less than full payment and junior claimholders receive some distribution. Appendix C provides a detailed classification for each of the firms in our sample.

As shown in Appendix C, absolute priority is upheld in 22% of prepacks and priority is upheld for secured creditors, but not for unsecured creditors, in 47% of prepacks. For the remaining 31% of the firms, priority is violated for secured creditors. These data can be compared with those reported by Weiss (1990) for traditional Chapter 11 organizations. As with prepacks, Weiss reports that absolute priority is upheld in 22% of the firms in his sample. Priority is upheld for secured (but not unsecured) creditors in 70% of his sample and priority is violated for secured creditors in 8% of his sample. These data suggest that unsecured creditors fare better and secured creditors fare worse in prepackaged bankruptcies than in traditional Chapter 11 reorganizations. Additionally, the data in Appendix C indicate that adherence to absolute priority is lower for pre- than for post-voted prepacks. Post-voted prepacks make up 35% of our sample, but they comprise 64% of those cases in which absolute priority is upheld. A chi-squared test of the hypothesis that the distribution of firms between pre- and post-voted prepacks is the same yields a  $p$ -value of 0.055 ( $\chi^2 = 5.78$ ).<sup>9</sup>

#### 4.3.3. *Percentage dollar deviations from absolute priority*

The data in Appendix C suggest that abrogations of absolute priority are frequent in prepackaged bankruptcies. To give some indication of whether these abrogations are economically significant, we calculate percentage dollar deviations from absolute priority as in Franks and Torous (1994).

If any category of claimholders receives more or less than the dollar amount due under absolute priority, that amount is the dollar deviation. The percentage dollar deviation from absolute priority is the dollar deviation from absolute priority divided by the total value paid to all claimholders in the firm. Thus, the percentage dollar deviations sum to zero across all claimholders in a firm.

Panel C of Table 2 presents the results of these calculations for the six categories of claimholders for the 38 firms for which we are able to obtain an estimate of the market value of equity. Although the frequency of deviations from absolute priority is high, the percentage dollar deviations are not large. As

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<sup>9</sup>It is interesting to note that Appendix C provides evidence of both positive and negative deviations from absolute priority for both creditors and equityholders. For example, in TIE/Communications (panel B.1) secured creditors have a recovery rate greater than 100% (127%) and unsecured creditors receive 100% recovery, implying that secured creditors have a positive deviation while common stockholders have a negative deviation from absolute priority.

reported above, unclassified and priority claims have zero deviations. On average, secured creditors receive 0.61% less of the total value than they are entitled under absolute priority; unsecured creditors receive 1.42% less of the total proceeds than they are entitled; and common stockholders receive 1.71% more of the total payments than they are entitled under strict adherence to priority. These statistics can be compared to those reported by Franks and Torous (1994) for out-of-court restructurings and traditional Chapter 11 reorganizations. The average percentage dollar deviation of  $-0.61\%$  for secured creditors in prepacks is smaller (in absolute value) than the  $-3.54\%$  and the  $-2.63\%$  reported by Franks and Torous for out-of-court restructuring and for Chapter 11 reorganizations, respectively.<sup>10</sup> The average percentage dollar deviation of  $-1.42\%$  for unsecured creditors in prepacks lies between the percentage dollar deviations of  $-4.39\%$  for out-of-court reorganizations and the percentage dollar deviation of  $-0.50\%$  for Chapter 11 filings. In addition, the average percentage dollar deviation of 1.71% for common stockholders in prepacks is smaller than the 9.51% for out-of-court restructurings and 2.28% for traditional Chapter 11 reorganizations. This number is also less than the 7.57% reported by Eberhart, Moore, and Roenfeldt (1990) and the 2.86% reported by Betker (1995a) for common stockholders in traditional Chapter 11 organizations. Finally, pre-voted prepacks have greater dollar percentage deviations from absolute than do post-voted prepacks; the average dollar percentage deviations in post-voted prepacks are trivial.

#### 4.3.4. *Post-prepack equity ownership*

Finally, we turn to the question of whether control of voting rights is transferred to creditors in a prepack. Columns 3 through 8 of Table 3 present the fraction of the equity received by each pre-bankruptcy category of claimholders on a fully diluted basis. In 45 of the 49 prepacks, creditors receive some common stock.<sup>11</sup> On average, creditors receive 64.5% of the equity in the reorganized firm. The bulk of the equity ownership that is transferred goes to unsecured creditors who, on average, end up with 50.6% of the equity. Furthermore, in 37 cases, creditors end up with at least 50% of the equity. Thus, in the typical prepack, control is transferred to creditors.

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<sup>10</sup>These data are taken from Table 6 in Franks and Torous (1994). For comparability with our data, we sum their percentages for bank and secured debt to obtain estimates of dollar percentage deviations for secured creditors. In similar fashion, we sum junior and senior debtholders to obtain an estimate of the dollar percentage deviations for unsecured creditors.

<sup>11</sup>In one of the remaining four firms, secured and unsecured creditors received cash and new debt securities equal to 100% of their claims; in the second, stockholders contributed substantial new capital to retain their interest; in the third, the firm is being liquidated and the partners have retained their claim to any residual proceeds from the sale; and in the final firm, a new investor received equity in exchange for investing substantial capital.

In 38 of the 49 firms, stockholders retain some fraction of the equity. In three other firms stockholders receive warrants or rights. On average, shareholders retain 21.6% of the equity in the reorganized firm on a fully diluted basis. To the extent that a difference exists between pre-voted and post-voted prepacks, creditors end up with a smaller fraction of the equity in pre-voted prepacks than in post-voted prepacks (61.2% versus 70.5%; Wilcoxon rank sum test  $z$ -statistic =  $-1.51$ ).

Gilson (1990) reports that in out-of-court restructurings and traditional Chapter 11 reorganizations, creditors end up with 41.9% and 79.2% of the equity, respectively, in the reorganized firm. For his sample of traditional Chapter 11 filings, Weiss (1990) reports that creditors end up with (roughly) 71.1% of the equity. Thus, in terms of the degree to which equity ownership is transferred to creditors, both pre- and post-voted prepacks lie between out-of-court restructurings and traditional Chapter 11 organizations.

Column 8 of Table 3 represents equity claims purchased by investors who contribute new equity capital to the firm. This infusion of new capital occurs in nine of the 49 prepacks. On average, across all prepacks, 'new' stockholders purchase 9.6% of the total equity. However, the average across all firms understates the importance of this source of new capital for those nine firms in which new capital was infused. In these nine firms, new equityholders purchased an average of 52.2% of the total shares.<sup>12</sup> When 'new' investors are included, old creditors plus new investors end up with 50% or more of the equity in 42 firms. Thus, it is uncommon for old shareholders to maintain a position of control in a firm reorganized by means of a prepack.

#### *4.4. Common stock event study*

In addition to the payoffs received, a measure of how claimholders fare in a reorganization is the change in the market value of securities at certain critical points during the reorganization process. Lack of data prevents such an analysis for all but common stockholders in our sample of prepacks. Even for common stockholders, the sample is limited to 21 firms with publicly traded common stock that traded on the announcement dates.

For these firms, one-day abnormal returns are calculated around three events: (1) the initial indication of a restructuring attempt, (2) the Chapter 11 filing date, and (3) the date of the confirmation of the plan by the bankruptcy court.

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<sup>12</sup>In four of the cases, the new equity is provided by 'old' claimholders. Thus, in only five of the cases does an outside investor supply new equity capital. Even this characterization of 'new' capital overstates the importance of outside investors in the reorganized firm because in one prepack (Southland Corp.) the outside investor (Ito-Yokado Co. Ltd.) was a Japanese affiliate of the firm, and in another (Kendall Co.) the investment group included the firm's CEO.

Table 3

Post-reorganization common stock ownership on a fully-diluted basis (in percent) for a sample of 49 firms that filed prepackaged bankruptcies over the period October 1986 through June 1993

The headings refer to the type of claim held prior to the bankruptcy filing. The number in parentheses is the number of firms in the sample, out of a possible 49, for which claimholders of this type received a nonzero share of the post-bankruptcy equity. The top number in each cell is the percentage of common stock held by this category of claimholders on a fully diluted basis following the firm's emergence from bankruptcy.

	All creditors	Secured creditors	Unsecured creditors	Preferred stockholders	Common stockholders or partnership	Management, ESOP, or contingent claimholders	New equity capital
All	64.5%	13.9%	50.6%	1.9%	21.6%	2.4%	9.6%
prepacks	(45)	(18)	(38)	(14)	(41)	(18)	(9)
Pre-voted prepacks	61.2 (30)	14.7 (12)	46.5 (25)	2.9 (11)	22.8 (28)	2.6 (11)	10.5 (6)
Post-voted prepacks	70.5 (15)	12.2 (6)	58.3 (13)	0.1 (3)	19.3 (13)	2.1 (7)	8.0 (3)

The market model procedure as described in, for example, Linn and McConnelli (1983) is used to calculate abnormal returns. Market model parameters are estimated over the interval from 250 days through 51 days before the announcement of the initial restructuring attempt using the Center for Research in Securities Prices value-weighted index. Because we use newswire stories, in most cases we are able to pinpoint whether the announcement occurred during trading hours. Thus, we use a one-day event period.

At the initial restructuring date, the average abnormal one-day return is  $-3.90\%$  with a  $z$ -statistic of  $-4.02$ . At the prepack filing date, the average abnormal return is  $+3.19\%$  with a  $z$ -statistic of  $+4.37$ . (The sample size for the filing date is 16 firms; 5 firms were delisted between the initiation of the restructuring and the bankruptcy filing date.) These results suggest that the initial announcement that the firm will undergo a distressed restructuring is bad news for stockholders, while the prepack filing is, apparently, good news. However, on each of these two dates, the fraction of negative and positive abnormal returns is about equal – 11 of 21 firms had positive abnormal returns on the initial restructuring announcement date and 10 of 16 firms had positive abnormal returns on the Chapter 11 filing date.

Confirmation of the plan by the court appears to be unambiguously good news – the average abnormal return on the plan confirmation date is  $+7.60\%$  with a  $z$ -statistic of  $+6.82$ . All but three of the 15 firms for which data are available experience a positive abnormal return on the confirmation date.

For out-of-court restructurings, Gilson et al. report a two-day average abnormal return of  $-1.6\%$  ( $t$ -statistic =  $+1.53$ ) for the initial restructuring announcement date and an average abnormal return of  $+0.7\%$  ( $t$ -statistic =  $+0.63$ ) for the resolution of the restructuring. Thus, both for the initiation and the resolution of the reorganization abnormal returns for prepacks have the same sign as out-of-court restructurings. The difference is that both abnormal returns are significant for prepacks and neither is significant for out-of-court restructurings.

For traditional Chapter 11 filings, Gilson et al. report a two-day average abnormal return of  $-6.3\%$  ( $t$ -statistic =  $-4.03$ ) for the initial restructuring announcement and an average abnormal return of  $-16.7\%$  ( $t$ -statistic =  $-6.68$ ) for the Chapter 11 filing date. Both the average abnormal returns on the initial restructuring announcement date and on the Chapter 11 filing date are more negative for distressed firms that end up in a traditional Chapter 11 than for prepacks and, of course, the average abnormal return of  $-16.7\%$  on the Chapter 11 filing date is dramatically different from the positive abnormal return on the Chapter 11 filing date for prepacks. These data suggest that, at least from common stockholders' perspective, prepacks are good news relative to a traditional Chapter 11. They also suggest that from the shareholders' perspective, prepacks have more in common with out-of-court restructurings than they do with traditional Chapter 11 reorganizations.

## 5. Related issues

It is interesting to consider whether the prepack 'story' is really an LBO story. For example, it could be that it is the LBO firms that undergo prepacks that are responsible for the much reduced time that prepacks spend in Court relative to traditional Chapter 11 reorganizations. As we note, 22 of the 49 prepacks in our sample underwent an LBO sometime during the seven years prior to the prepack. We investigate whether this set of prepacks differs systematically from other prepacks by separating the sample into the 22 firms that underwent an LBO at any time over the seven years prior to the prepack filing and all other firms. The various statistics discussed in Section 4 are calculated for both sets of firms. Based on a chi-squared test, the relative frequency with which LBO firms and non-LBO firms file pre- and post-voted prepacks and the relative frequency with which priority is violated by pre- and post-voted prepacks are indistinguishable ( $p$ -values all greater than 0.10). Similarly, based on a Wilcoxon rank sum test, the time spent in negotiating prior to filing, the time spent in Chapter 11, the dollar fees divided by pre-filing assets, and the total firm recovery rates are indistinguishable between the sample of LBO and non-LBO firms ( $p$ -values all greater than 0.10). Apparently, the attributes and outcomes of the prepack process are inherent in the process and independent of whether the firm has previously undergone an LBO.

We also consider the question of why firms choose to reorganize by means of a prepack rather than an out-of-court restructuring or a traditional Chapter 11. Miller (1991) argues that the federal tax code encourages bankruptcy filings by distressed firms because the tax code treats forgiven debt as ordinary taxable income when a firm reorganizes out of court. If creditors were to forgive the same debt in Chapter 11, the debt forgiveness does not enter into taxable income. Thus, all else equal, the tax treatment of debt forgiveness provides an incentive for the firm to file a Chapter 11 rather than reorganize out of court.<sup>13</sup> Following Miller, McConnell, and Servaes (1991) suggest that, if the tax treatment of debt forgiveness is important, prepacks may be a low-cost way of achieving those benefits for a firm that would otherwise have reorganized outside of court. Betker (1995b) explores this question empirically for a sample of 41 prepacks that took place over the period 1986 through 1993, and reports that none of the firms in his sample would have incurred current taxes from debt forgiveness had they reorganized out of court rather than through a prepack. Thus, based on his data, avoiding the tax consequences of debt forgiveness does not appear to have been a motive for firms to file prepacks rather than to reorganize outside of court.

However, Betker notes that a second tax advantage of a Chapter 11 is that firms are allowed more liberal recapture of net operating losses (NOLs) than when they reorganize out of court if ownership is transferred to creditors in the reorganization. For his sample, Betker reports an average tax saving of 3.1% of post-emergence assets (which amounts to an average of \$8.85 million per firm) due to the increased recapture of NOLs in a prepack relative to an out-of-court restructuring. His conclusion is that the tax advantage of prepacks is sufficiently large to affect a firm's choice of restructuring method. A further twist on tax effects is that the tax provision allowing greater recapture of NOLs by bankrupt firms expired in January 1995 (*Wall Street Journal*, December 23, 1994). Only time will tell whether this change in the tax law affects the rate at which firms file prepacks.

Of course, as noted by Wruck (1990), reorganizations of financially distressed firms are complex multiparty transactions in which the various participants have conflicting interests. One of the complications that can arise in the reorganization of a financially distressed firm is the well-known 'free-rider/holdout' problem in which creditors individually have an incentive not to exchange their old securities for new ones with less favorable terms even though the exchange would benefit participants collectively. Each creditor individually has an incentive to free ride on the concessions granted by other creditors.

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<sup>13</sup>In this case, as in many others, all else is not always equal. An insolvent firm may write down its debt to the extent of its insolvency without incurring taxable income. Gilson (1993) gives a detailed description of the tax treatment of out-of-court restructurings and Chapter 11 reorganizations.

Because all creditors must exchange their securities in a Chapter 11 reorganization, McConnell and Servaes (1991) argue that prepacks may be a low-cost way of resolving this type of freerider/holdout problem. That is, creditors who would ordinarily hold out in an out-of-court restructuring may be willing to cooperate in a Chapter 11 reorganization.

Our sample provides some indirect evidence on the role of prepacks in resolving this type of problem. Specifically, in nine of the 49 prepacks in our sample, the firm simultaneously mailed to participants both a solicitation for an out-of-court exchange offer and a ballot for a prepack. The terms of the out-of-court restructuring and the prepack were identical. In each case, the debtor firm indicated that the reorganization would be completed out of court if the exchange offer received sufficient support. Because each of the nine firms ended up in our prepack sample, the out-of-court restructuring attempt obviously failed. In four of these nine cases, we were able to determine the level of support for both the proposed exchange offer and for the proposed prepack. In each of these four cases, at least one class of claimholders gave a *higher* level of support for the prepackaged plan than for the proposed exchange offer. Apparently, claimholders were more willing to participate in the prepack, which assured 100% participation by claimholders, than in the identical exchange offer, which did not guarantee 100% participation. Prepacks thus appear to provide a mechanism for resolving at least one type of freerider/holdout problem that occurs in reorganizations of financially distressed firms.

Finally, McConnell and Servaes (1991) and Jensen (1991) argue that a court ruling in the LTV bankruptcy case exacerbated the freerider/holdout problem in distressed reorganizations and, as a consequence, increased the likelihood that a financially distressed firm will file a Chapter 11 rather than reorganize out of court. In 1986, LTV negotiated an exchange offer with some of its creditors. In the exchange, bondholders received new bonds with a market value substantially below face value. LTV filed for Chapter 11 protection shortly thereafter. In 1990, the court ruled that the bondholders who had participated in the exchange offer (and not all had) could only value the bonds for purposes of a bankruptcy claim at the bonds' market values, not their face values. Had LTV undergone a Chapter 11 instead of an informal reorganization, and had all creditors been forced to participate on a pro rata basis, the relative market value of all claims would have been preserved. Prior to the LTV decision, the common practice had been that creditors' claims were recognized at face value even if they had been issued at a discount as part of an out-of-court reorganization. Thus, the LTV decision may have provided further incentive for creditors individually to decline to participate in an out-of-court reorganization.

On the presumption that prepacks do provide a less costly mechanism for resolving financial distress than a traditional Chapter 11, McConnell

and Servaes argue that a prepack may be a low-cost mechanism for solving any freerider/holdout problem exacerbated by the LTV ruling. Certainly, the significant uptick of prepacks after 1990 is consistent with that argument. However, in April 1992, the Court substantially reversed the LTV decision. No downturn in prepacks has occurred following the reversal. Still, it could be that the LTV decision spurred the use of prepacks as a low-cost mechanism for resolving the freerider/holdout problem and now that attorneys have mastered the procedure, it will continue to be used toward that end.

## **6. Commentary and conclusions**

The main objective of this study has been to provide extensive descriptive information on prepackaged Chapter 11 bankruptcies to supplement existing data on out-of-court reorganizations and traditional Chapter 11 bankruptcy proceedings. Having completed that task, what inferences can we draw from the results? At first glance, it is tempting to conclude that prepacks offer most (or all) of the advantages of a traditional Chapter 11 at lower cost. For example, we find that: (1) the average direct cost of resolving financial distress as a fraction of total assets is less in a prepack than in a traditional Chapter 11 (as reported by Warner, 1977; Weiss, 1990); (2) both the time spent in bankruptcy and the total time spent in reorganizing the firm are less with a prepack than with a traditional Chapter 11 (as reported by Weiss, 1990; Gilson et al., 1990; Franks and Torous, 1994); (3) the recovery rate by creditors is higher in a prepack than in a traditional Chapter 11 (as reported by Franks and Torous, 1994); (4) the incidence of violations of strict absolute priority is roughly the same as in traditional Chapter 11 bankruptcies (as reported by Weiss, 1990); and (5) the transfer of control to creditors is similar to that in traditional Chapter 11 reorganizations (as reported by Gilson, 1990; Weiss, 1990). These data appear to support the conclusion that prepacks are a 'cheap' substitute for traditional Chapter 11 filings. Unfortunately, such a conclusion is premature.

An equally compelling argument can be made that prepacks are actually substitutes for out-of-court reorganizations in which the prepack offers an inexpensive solution to a freerider/holdout problem or an inexpensive way to achieve the tax savings of a Chapter 11. Suppose, for example, that the costs of a traditional Chapter 11 are significantly greater than the costs of an out-of-court reorganization. When confronted with high costs, even very recalcitrant creditors may be coerced into an out-of-court reorganization – or at least enough of them for the reorganization to take place. If, however, a prepack is a low-cost mechanism for coercing all creditors to participate, the firm may elect a prepack rather than an out-of-court restructuring.

In sum, the question of whether prepacks substitute for out-of-court reorganizations or traditional Chapter 11 filings cannot be determined with the data presented here. More likely, some creditors and shareholders who would have reorganized the firm out of court now choose to reorganize by means of a prepack, and other creditors and shareholders who would have opted for a traditional Chapter 11 now choose to reorganize by means of a prepack.

A further contribution of this paper has been to explore the distinction between pre-voted and post-voted prepacks. We find that: (1) firms that file pre-voted prepacks spend less time in bankruptcy court, but spend more time negotiating prior to filing the bankruptcy petition than do post-voted prepacks; (2) direct costs as a fraction of assets are lower for pre-voted prepacks than for post-voted prepacks; (3) recovery rates are higher for pre-voted prepacks than for post-voted prepacks; (4) percentage dollar deviations from absolute priority are smaller in magnitude in post-voted than in pre-voted prepacks; and (5) a lower fraction of equity is transferred to creditors in pre-voted prepacks than in post-voted prepacks.

From an economic perspective, the results reported in this paper support the intuitively appealing idea that the various mechanisms for reorganizing financially distressed firms lie along a continuum, with creditors and debtors free to choose the form that provides the greatest benefit at the lowest cost given their unique circumstances. We provide information that may be useful to creditors and debtors confronted with that choice.

## Appendix A

Table 4  
Descriptive data on firms filing prepacks

Dollar value of assets are from the annual financial statements for the year-end preceding the Chapter 11 filing and are given in millions of dollars. Abbreviations for one or more classes of publicly traded securities are *C* for common stock, *P* for preferred stock, and *D* for debt. A prepack is classified as 'pre-voted' if the claimholders voted to accept the plan of reorganization prior to the Chapter 11 filing. A firm is identified as an 'LBO' firm if the firm underwent a leveraged buyout in the seven years preceding the Chapter 11 filing.

Firm	Chapter 11 filing date	Assets (\$ millions)	Type of publicly traded securities	Pre-voted	LBO
AM International	5/17/93	441.4	<i>C, P, D</i>	no	no
Adience	2/22/93	111.5	<i>D</i>	yes	no
Alleco	6/1/92	36.1	<i>D</i>	no	yes
ARIX Computer	12/20/91	9.7	<i>C</i>	yes	no
Arizona Biltmore	2/20/90	98.5	none	yes	no

Table 4 (continued)

Firm	Chapter 11 filing date	Assets (\$ millions)	Type of publicly traded securities	Pre-voted	LBO
Barry's Jewelers	2/26/92	158.8	C, D	no	no
Caiton	3/9/93	197.0	C, D	yes	no
Charter Medical	6/2/92	1347.1	D	yes	yes
Cherokee Group	4/23/93	214.2	C, D	yes	yes
Circle Express	9/11/90	79.3	C, D	yes	no
Crystal Oil	10/1/86	341.7	C, D	yes	no
Divi Hotels	11/27/91	138.1	C, D	no	no
E-II Holdings	7/15/92	798.7	D	no	yes
Edgell Communications	12/23/91	180.8	none	yes	yes
Edisto Resources	10/26/92	359.5	C, P, D	no	no
Endevco	6/4/93	114.5	C	yes	no
Farley	9/24/91	2407.9	D	no	no
Gaylord Container	9/11/92	965.7	C, D	yes	no
Hadson	10/15/92	172.6	C, D	yes	no
JPS Textile Group	2/7/91	540.6	D	yes	yes
Kendall International	5/20/92	717.8	none	yes	yes
Kindercare Learning Centers	11/10/92	486.9	C, D	no	no
Kroy	5/15/90	26.0	none	no	yes
Ladish	2/19/93	218.8	D	yes	yes
LIVE Entertainment	2/2/93	297.0	C, P, D	yes	no
MB Holdings	12/10/91	204.8	none	yes	yes
MG Holdings	6/27/92	328.4	D	yes	yes
Mediagenic	10/4/91	33.5	C	yes	no
Memorex Telex	1/6/92	1736.2	C, P, D	yes	yes
Munsingwear	7/3/91	16.7	C, D	no	no
NACO Finance	5/9/91	175.6	D	no	no
Olympia & York Water St.	5/7/93	n.a.	D	no	no
Petrolane Gas Service	5/21/93	896.8	D	yes	no
Price Communications	5/8/92	92.3	C, D	no	no
Republic Health	12/20/89	658.3	D	yes	yes
Resorts International	11/14/89	1034.6	C, P	no	yes
Rymer Foods	2/3/93	95.3	C, P, D	yes	no
SCI Television	3/4/93	1004.9	D	yes	yes
SPI Holdings	9/17/92	610.2	P, D	yes	yes
Southland	10/24/90	3438.8	P, D	yes	yes
Specialty Equipment	12/24/91	451.3	D	no	yes
Sprouse-Reitz Stores	11/27/91	85.4	C	no	no
Sunshine Precious Metals	3/9/92	221.9	D	yes	no
TIE/Communications	4/15/91	132.4	C	no	no
Trump Plaza Funding	3/9/92	378.4	D	yes	yes
Trump Taj Mahal Funding	7/16/91	845.8	D	yes	yes
Trump's Castle Funding	3/9/92	408.3	D	yes	yes
USG	3/17/93	1659.0	C, D	yes	no
West Point Acquisition	6/9/92	2413.8	D	yes	yes

## Appendix B

Table 5

Modifications to initial plans of prepackaged bankruptcies

Appendix B describes the changes in the treatment of claimholders between the initial plan of reorganization filed concurrently with the Chapter 11 filing and the plan of reorganization that was ultimately confirmed for each of the 11 firms in our sample of prepacks where the first plan was not confirmed.

### *Panel A. Modifications to pre-voted plans of reorganization while in Chapter 11*

*Southland* awarded warrants to each class of bondholders and the preferred stockholders. The old equityholders provided the stock to cover exercise. In addition, one class of bondholders (the 16.75% subordinated debenture holders), who were originally scheduled to receive, per \$1000 face amount of claim, \$500 principal amount of series A debentures (with a 14-year maturity and an annual interest rate of 4.5%) and 28 shares of new common were, instead, awarded a choice between the original package of securities plus six warrants and a second package consisting of \$250 principle amount of second priority senior subordinated debentures (with a 19-year maturity and an interest rate of 12%) plus 28 shares of new common.

*Sunshine Precious Metals*, a subsidiary of Sunshine Mining Company, modified the terms of the new bonds received by creditors so the bonds could be 'put' to the parent firm in exchange for stock in the parent.

### *Panel B. Modifications to post-voted plans of reorganization while in Chapter 11*

*AM International* awarded preferred stockholders warrants in addition to common stock. If exercised, the warrants would increase the equity ownership by the old preferred stockholders from 2% to over 15%; the warrants were exercisable at \$18 for three years. Shortly after emerging from Chapter 11, the firm's common stock was trading at \$9.50 per share.

*Alleco's* single shareholder, MML, Inc., agreed to infuse \$1 million in cash into the firm in the form of a purchase of 10 shares of preferred stock at \$100,000 per share. The infusion had the effect of increasing recovery by creditors from about 40% to as much as 45%.

*Divi Hotels* made minor changes to bank agreements, but made no change in recovery rates.

*E-II Holdings's* second plan increased the estimated value of the firm, thereby improving the recovery rate for junior debtholders. The plan also gave senior debtholders the right to receive payment in equity rather than debt, thereby giving senior creditors an option to maintain control of the firm.

*Edisto Resources* made minor changes to bank agreements, but made no change in recovery rates.

*Farley* had an unfunded pension liability estimated at \$55.3 million. The first plan contained a class for retiree claims whose claims were collateralized by stock in another firm, but contained no specific payment plan. The Pension Benefit Guaranty Corporation (PBGC), which was not identified specifically as a creditor in the original plan of reorganization, objected to the treatment of the retiree claims. Two additional plans also failed to receive confirmation. The fourth plan, which listed the PBGC as a separate class, contained a specific payment schedule for funding the pension plan.

*Kindercare Learning Centers* made minor changes to bank agreements and increased the cash option for reset noteholders.

*NACO Finance* agreed to pay the fees of \$1 million in cash, \$450 thousand in secured notes, and 0.3% of the new common stock to the financial advisor of the unofficial noteholders' committee.

*Resorts International's* equityholders infused an additional \$20 million which was divided among debtholders holding claims in excess of \$931 million.

## Appendix C

Table 6

Recovery rates for 49 firms that filed prepackaged bankruptcies over the period January 1986 through June 1993, tabulated according to whether they were pre- or post-voted and whether priority is upheld

Because unclassified and priority claims are always paid in full, these categories are excluded from the table. Secured and unsecured creditors frequently include trade creditors. These creditors typically are paid in full. In our sample miscellaneous and general claims receive full payment in 93.7% of the cases. To simplify the presentation, the payoffs to these claimants are not shown in the table. Each of the remaining four categories may encompass more than one class of claimholder. Within each category, payoffs may differ across classes in that category. When the treatment differs across classes within a category of creditors (e.g., different classes of unsecured creditors receive different payoffs), the table gives the range of recovery rates within that category. For common stock, the table provides the proportion of equity ownership received in the new firm on an undiluted basis rather than the fraction of the claim received.

Panel A of the table contains the pre-voted prepacks and panel B contains the post-voted prepacks. To document the degree to which absolute priority is upheld in prepacks, panels A and B are each separated into three sections. Sections A.1 and B.1 list those firms for which we determine that absolute priority is upheld; sections A.2 and B.2 present those firms where absolute priority is violated for unsecured creditors; and sections A.3 and B.3 list the firms for which absolute priority is violated for both secured and unsecured creditors.

Firm	Secured	Unsecured	Preferred	Common <sup>a</sup>
<i>Panel A. Pre-voted prepacks (sample size = 32)</i>				
<i>A.1. Priority upheld (4 of 32 = 12.5%)</i>				
ARIX Computer	100%	107% <sup>b</sup>	n.a.	33.9%
JPS Textile Group	100 <sup>c</sup>	100 <sup>b,c</sup>	6.7 to 100 <sup>b</sup>	0
Sunshine Precious Metals	100 <sup>b,c</sup>	100 to 120 <sup>b</sup>	n.a.	90.6
Trump Plaza Funding	120 <sup>c</sup>	100	n.a.	50.0
	+ partnership			
<i>A.2. Priority violated for unsecured creditors (18 of 32 = 56.3%)</i>				
Calton	100% <sup>c</sup>	71.2 to 119.1% <sup>b</sup>	n.a.	7.2%
Cherokee Group	100	39.1 to 60.7 <sup>b</sup>	7.9 to 21.2 <sup>b</sup>	8 + warrants
Circle Express	100 <sup>c</sup>	13 <sup>b</sup>	n.a.	3.7
Crystal Oil	100 to 109 <sup>b</sup>	83 to 91.8 <sup>b</sup>	n.a.	36.2 + warrants
Endevco	100	72.7 <sup>d</sup>	26.3	63.4
Gaylord Container	100 <sup>c</sup>	57.3 to 103 <sup>b</sup>	n.a.	72
Hadson	100 <sup>c</sup> to 118.2 <sup>b</sup>	60	n.a.	33.3
Kendall International	100	31 to 104 <sup>b</sup>	n.a.	warrants + rights
Ladish	100	common	n.a.	5
LIVE Entertainment	100	91.1	37	36 to 55
MB Holdings	100 <sup>c</sup>	50.6 <sup>b</sup>	0 to 4.6 <sup>b</sup>	0
MG Holdings	100	78 <sup>b</sup>	n.a.	3.9
Petrolane Gas Service	100 <sup>c</sup>	27.1 <sup>b</sup>	n.a.	\$9001.
Rymer Foods	n.a.	74.0 <sup>b</sup>	8.7 <sup>b</sup>	28.5
Southland	100 <sup>c</sup>	28.5 to 75.1 <sup>b</sup>	6 <sup>b</sup>	5
Trump Taj Mahal Funding	100 <sup>b,c</sup>	0 to 52	n.a.	50
		+ partnership		
USG	100 <sup>c</sup>	13.9 <sup>b</sup> to 100	n.a.	3
West Point Acquisition	100 <sup>c</sup>	common	common	0.003
	+ common			

Table 6 (continued)

Firm	Secured	Unsecured	Preferred	Common <sup>a</sup>
<i>A.3. Priority violated for secured creditors (10 of 32 = 31.2%)</i>				
Adience	75 <sup>b</sup> to 100%	100%	n.a.	45%
Arizona Biltmore	90.2 to 100	68 to 100	n.a.	100 <sup>c</sup>
Charter Medical	98.5 to 100 <sup>c</sup>	12.6 to 74.0 <sup>b</sup>	2.9 to 7.1 <sup>b</sup>	3
Edgell Communications	91.5%	common	common + warrants	5.3 + warrants
Mediagenic	6.4 to 177 <sup>b</sup>	13.3 <sup>b</sup>	n.a.	11
Memorex Telex	86.7 <sup>b</sup> to 100 <sup>c</sup>	10.6 to 21.7 + rights	0.6 to 1.7 <sup>b</sup>	warrants
Republic Health	80.8 to 100	17.8 to 65 <sup>b</sup>	6.9 <sup>b</sup>	4.1
SCI Television	92.7 <sup>b</sup> to 100 <sup>c</sup>	0 to 3.4 <sup>b</sup>	n.a.	0
SPI Holdings	63.6 <sup>b</sup> to 100 <sup>c</sup>	100 <sup>c</sup>	23.7 <sup>b</sup>	32 <sup>f</sup>
Trump's Castle Funding	76 to 100 + partnership	53 to 54	n.a.	50
<i>Panel B. Post-voted prepacks (sample size = 17)</i>				
<i>B.1. Priority upheld (7 of 17 = 41.2%)</i>				
Alleco	100%	100% <sup>c</sup>	n.a.	100% <sup>f</sup>
E-II Holdings	n.a.	46.3 to 92.4 <sup>b</sup>	n.a.	0
NACO Finance	n.a.	100 <sup>b</sup>	n.a.	15
Olympia & York Water St.	26.9 <sup>b</sup>	0	n.a.	0
Specialty Equipment	100 <sup>b,c</sup>	52.5 <sup>b</sup>	0	0
Sprouse-Reitz Stores	100	100 <sup>c</sup>	n.a.	100
TIE/Communications	127 <sup>b</sup>	100	n.a.	25
<i>B.2. Priority violated for unsecured creditors (5 of 17 = 29.4%)</i>				
AM International	n.a.	69% <sup>b</sup>	5.3% <sup>b</sup>	1%
Barry's Jewelers	100 <sup>c</sup> + warrants	24.8 <sup>b</sup>	n.a.	7
Edisto Resources	100 <sup>c</sup>	89.8 <sup>b</sup>	n.a.	10 + warrants
Farley	100	46 to 106 <sup>b</sup>	common	0.003
Price Communications	n.a.	9.9 <sup>b</sup> to 100 <sup>c</sup>	n.a.	3.5
<i>B.3. Priority violated for secured creditors (5 of 17 = 29.4%)</i>				
Divi Hotels	< 100 <sup>a</sup> to 100% <sup>c</sup>	22.8 to 48.4% <sup>b</sup>	7% <sup>b</sup>	3.1%
Kindercare Learning Centers	96.4 to 149 <sup>b</sup>	29.4 to 149 <sup>b</sup>	n.a.	13.5 + warrants
Kroy	89.5 to 100	18.6 <sup>b</sup> to 20	n.a.	rights
Munsingwear	< 100 <sup>a</sup> to 100	21.7 <sup>b</sup>	n.a.	10.3
Resorts International	85.3 <sup>b</sup> to 100	5.7 to 33 <sup>b</sup>	n.a.	0

n.a. (not applicable) indicates there were no claims for that category of claimholder.

<sup>a</sup>Percentage ownership post-bankruptcy on an undiluted basis.

<sup>b</sup>Settlement includes equity.

<sup>c</sup>Some claimholders are deemed 'impaired', despite receiving 100% of their claim.

<sup>d</sup>Unsecured creditors receive shares in an asset trust.

<sup>e</sup>Firm is being liquidated. The partnership retains the right to any residual cash flows.

<sup>f</sup>The equityholders will pay in cash to maintain their claim.

<sup>a</sup>Some secured creditors received their collateral (worth less than the claim) in settlement of the claim.

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