Agency Problems of Debt, Convertible Securities, and Deviations from Absolute Priority in Bankruptcy

Michael Frierman and P. V. Viswanath

Abstract

It has been suggested that convertible debt can be used to reduce the tendency toward excessive risk taking in a firm that includes debt in its capital structure. We show that the ability of convertible debt to perform this function is greatly reduced if stakeholders can trade in derivative securities with payoffs contingent on the cash flows of the firm. We show, further, that bankruptcy courts can ensure the same result precisely by deviating from absolute priority. Our model explains two real-world phenomena; one, why bankruptcy law seems to be structured in such a way as to favor equity holders and facilitate deviations from absolute priority, and two, why small firms are more likely to use convertible debt.