Abstract

Under U.S. Bankruptcy Code, equity holders can restructure different debt classes at a time. Recognizing this allows us to endogenize, in continuous time, not only the restructuring threshold but also the restructuring order of senior and junior classes. Unlike previous studies, sequential restructuring explains absolute priority violation (APV) not just among debt and equity but also among debt classes. The extent of APV leads to positive credit spreads even if senior creditors are fully secured and virtually immune to default risk. Moreover, sequential restructuring can lead to reversals in the credit spreads. We provide sufficient conditions for avoiding reversals.