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Shareholder litigation, shareholder–creditor conflict, and the cost of bank loans☆

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ABSTRACT

I study how shareholder litigation affects the cost of bank loans via its impact on the distribution of bankruptcy estate and the conflict of interests between shareholders and creditors. Using a natural experiment based on a ruling by the Ninth Circuit Court of Appeals, I find that increasing the difficulty of class action suits decreases loan spreads. The effect is stronger for firms with higher institutional ownership, which is consistent with the argument that class actions suits help shareholders extract wealth from creditors when the firm is in bankruptcy. Further analysis shows that the effect is weaker for firms with stronger creditor protection in bankruptcy.

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1. Introduction

Conflicts between shareholders and creditors often become exaggerated when a firm is in financial distress (Ayotte et al., 2013). Shareholders may take extreme actions to preserve their value, often at the expense of other stakeholders, as the firm becomes financially distressed. The literature has suggested that shareholders may delay default (Andrade and Kaplan, 1998, Adler et al., 2013), take excessive risk (Aghion et al., 1992), or pay dividends (Hotchkiss et al., 2014) during financial distress to extract wealth from the firm, which often results in substantial value loss of creditors. This paper studies another often ignored source of shareholder–creditor conflict arising in bankruptcy, the distribution of bankruptcy estate between shareholders and creditors. Specifically, I study how shareholders may use shareholder litigation to extract wealth from creditors in bankruptcy.

Shareholder litigation via class action suits is often considered an important stopgap measure in corporate governance and shareholder rights, and is the most frequently maligned legal check on managerial misconduct within corporations (Bhagat and Romano, 2002 and Appel, 2014), especially when primary governance mechanisms fail (Romano, 1991). However, shareholder litigation has not been without controversy. Many argue that most class action suits are frivolous and often lead to substantial wealth extractions by lawyers at the expense of shareholders (Romano, 1991 and Johnson et al., 2000). It is often ignored that shareholder litigation may help shareholders extract wealth from other stakeholders of the firm. This paper explores how shareholders may extract wealth from creditors via shareholder litigation.

Shareholder litigation may help shareholders extract wealth from creditors if shareholder litigation involves financial distress or bankruptcy. The absolute priority rule makes clear that a holder of any claim junior to other claims will not receive any distribution unless senior claims are fully satisfied. Thus, unless creditors are paid in full, shareholders generally do not receive

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a distribution from a debtor's estate. However, some shareholders, apparently in violation of the absolute priority rule, have achieved recoveries by bringing class action law suits against the debtor, the officers and directors, and third parties.

While claims against the debtor itself are often discharged in bankruptcy proceedings, claims against directors and officers and claims against other third party gatekeepers (underwriters and auditors) are not. For example, shareholders of Enron and WorldCom were able to recover billions of dollars from directors, officers, and third party gatekeepers. Shareholders often argue that directors and officers are non-debtors and the Bankruptcy Code's automatic stay does not apply to claims against directors and officers. Therefore, shareholders can often recover some wealth from suing the directors and officers. For example, in the case of Gillman vs Continental Airlines, the judge argues that directors and officers liability insurance (D&O insurance) proceeds are not property of the bankruptcy estate and therefore are not subject to the automatic stay.[1]

Although the wealth recovered by shareholders from directors, officers, and third parties is not directly from the company or the debtor itself, it belongs to the same pool of funds that creditors could potentially have claims against. Claims contained in a shareholders' lawsuit are often also found in complaints filed by the creditors against the same officers, directors, and third parties. Therefore, the wealth recovered by shareholders via shareholder litigation can potentially decrease the amount that creditors can recover during bankruptcy, if the total liability or capacity of directors, officers, and third parties is, to some extent, fixed.

The conflict of interest is evident in many recent bankruptcy cases that involve shareholder litigation, for example, in the case of the World Health Alternatives bankruptcy. In fall 2005, shareholders of World Health Alternatives filed multiple suits against the company and directors and offices. In February 2006, the company filed for bankruptcy, and then the company was dropped as a defendant from the shareholder litigation. In the fall of 2006, the shareholder litigation case was settled with settlement payment to be paid mostly by D&O insurance. Then in May 2007, the trustee initiated a proceeding against the company's former directors and officers for their breaches of fiduciary duties and unjust enrichment. The trustee petitioned the bankruptcy court to enjoin the approval of shareholder litigation settlement. The court reached the conclusion that "It appears that the proceeds of the debtor's insurance policy are not the property of the estate" and therefore the trustee "has no right to any Coverage A proceeds" of the D&O insurance. In this case, the settlement of shareholder litigation reduces the recovery of creditors. A more recent case is the bankruptcy case of MF Global Holdings. The bankruptcy judge first ruled in April 2012 that D&O insurers could advance the directors' and officers' individual defense (in class action law suits) subject to a "soft cap" of $30 million. And in a subsequent ruling, the amount of the cap was raised to $43.8 million. The cap on the amount that can be spent on settling class action law suits in this case reflects the conflict between shareholders and creditors in pursuing claims against the same pool of funds, D&O insurance proceeds in this case.

Park (2013) shows that shareholder litigation involving bankruptcy is quite common, it is therefore important to understand such an often ignored conflict of interest between shareholders and creditors. In this paper, I explore how the *ex post* wealth extractions by shareholders from creditors via shareholder litigation can affect the *ex ante* cost of corporate loans. I focus on bank loans instead of public bonds because bondholders can also sue the company via class action law suits, and therefore the threat of class action law suits can have an ambiguous impact on the cost of bonds.

The threat of shareholder litigation can affect the cost of bank loans via three different channels. The effect of shareholder litigation on the distribution of the bankruptcy estate discussed above would suggest that the threat of shareholder litigation can increase the cost of bank loans because shareholder litigation helps shareholders extract wealth from lenders. I call this channel the bankruptcy distribution channel. Shareholder litigation can also increase the cost of bank loans via the traditional value destruction channel, i.e., shareholder litigation leads to wealth extractions by lawyers (Alexander, 1991; Romano, 1991), worsening performance (Graham et al., 2008), or reputational loss (Klein and Leffler, 1981; Karpoff et al., 2008; Deng et al., 2014), all of which reduce firm value. Finally, the threat of shareholder litigation can also decrease the cost of bank loans because the threat of shareholder litigation can help discipline managers and thereby increase firm value. I call this channel the discipline channel.

To empirically examine how the threat of shareholder litigation affects the cost of bank loans, I exploit plausibly exogenous variation of the threat of class action shareholder litigation generated by a ruling of the Ninth Circuit Court of Appeals in 1999. This ruling makes it difficult for shareholders to engage in class actions and disproportionately affects firms in the Ninth Circuit.[2] I estimate the effect of the ruling using the difference-in-differences method, in which the treated group consists of firms in the Ninth Circuit and the control group consists of other firms. I find that reducing the threat of class actions by the ruling reduces loan spreads, which is consistent with both the bankruptcy distribution channel and the value destruction channel. On average, the ruling decreases loan spreads by about 10%.

Because the ruling was made in 1999 and the Ninth Circuit covers California, the results can instead be driven by the technology bubble, which also happened around 1999 and 2000. To mitigate such a concern, I first exclude all high-tech firms as the tech bubble should most likely affect high-tech firms. I find that the results remain qualitatively similar when high-tech firms are excluded. I then compare the effects of the ruling on private firms versus public firms. If the tech bubble drives the results, it should equally affect private firms. But on the other hand, if the ruling drives the results it should be more likely to affect public firms because the ruling only affects firms with dispersed ownership. The results show that the ruling has no effect on private firms, which further suggests that the main results are unlikely to be driven by the tech bubble.

[1] However, in other cases, the judges have argued that the insurance proceeds belong to the bankruptcy estate.

[2] The Ninth Circuit covers Alabama, Arizona, California, Hawaii, Idaho, Nevada, Oregon, and Washington.

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