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Shareholder litigation rights and the cost of debt: Evidence from derivative lawsuits☆

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ABSTRACT

Exploiting the staggered adoption of universal demand (UD) laws as exogenous shocks to filing derivative lawsuits, we find that weakened shareholder litigation rights cause a significant increase in the cost of debt. Deteriorated corporate governance, increased information asymmetry, and heightened managerial risk-taking are the underlying channels. Shareholders respond to weakened litigation rights by providing managers with less risk-taking incentives. Overall, our findings suggest that the shareholder litigation rights are important to debtholders.
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1. Introduction

Shareholder rights are of vital importance to firms. La Porta et al. (1998) argue that among different types of shareholder rights, the availability of litigation rights, which allow oppressed shareholders to make legal claims against directors and officers, is perhaps the most important one.[1] While there is abundant evidence on how litigation rights affect shareholders (e.g., Jensen and Ruback, 1983; Shleifer and Vishny, 1997), it is less clear how debtholders perceive such rights. In this paper, we exploit state-level law changes that exogenously reduce shareholder litigation rights to investigate the causal effect of shareholder litigation rights on the cost of debt.

The relation between shareholder litigation rights and the cost of debt is theoretically ambiguous. On the one hand, stronger shareholder litigation rights can reduce the cost of debt. Shareholder litigation is a source of corporate governance. Better corporate governance ensures that manager act in the best interest of the firm and improves profitability, leading to a lower cost of debt (Kraakman et al., 1993; Kinney, 1994; Ferris et al., 2007). Further, the threat of forced replacement and reputation losses in shareholder litigation can discipline managers and discourage excessive risk-taking (Kinney, 1994; Ferris et al., 2007;

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[1] Kraakman et al. (1993) also argue that shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers. La Porta et al. (1997, 2000) emphasize the importance of laws in resolving agency problems and protecting shareholder interests.

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Gormley and Matsa, 2011; Donelson and Yust, 2014; Liu et al., 2016). Therefore, stronger shareholder litigation rights can also reduce the cost of debt through a risk-taking channel.

On the other hand, stronger shareholder litigation rights can increase the cost of debt. Good corporate governance may exacerbate the conflicts between shareholder and debtholders, leading to a wealth transfer from debtholder to shareholders though risk-shifting (Smith and Warner, 1979; John et al., 2008; Chava et al., 2009). Debtholders will demand a higher premium in anticipating of the risk-shifting. Further, frivolous litigations often lead to substantial wealth transfers to attorneys at the expense of the company (Romano, 1991; Johnson et al., 2000). Therefore, debtholders will require a premium if stronger shareholder litigation rights result in more frivolous litigations and lower firm value.

Given these opposing predictions, how debtholders weight various costs and benefits of shareholder litigation rights is ultimately an empirical question. Prior studies focus on corporate policies changes after the actual lawsuits (e.g. Ferris et al., 2007; Liu et al., 2016). However, since the lawsuit is an equilibrium outcome and shareholder litigation rights are difficult to quantify, identifying a causal effect is empirically challenging. To overcome this identification challenge, we exploit the staggered state-level adoption of universal demand (UD) laws as quasi-exogenous shocks to the difficulty in filing derivative lawsuits to shed some light on the effect of shareholder litigation rights on the cost of debt. Section 2 provides more institutional background on the law change.

Shareholders can file derivative lawsuits on behalf of the corporation to replace entrenched managers.[2] UD laws impose a "universal demand" requirement, which requires plaintiff shareholders to seek approvals from the board and allow the board to take corrective actions prior to initiating a derivative lawsuit. As derivative lawsuits typically name directors as defendants, directors will almost inevitably decide against proceeding with the litigation (Swanson, 1992). Therefore, the adoption of UD laws raise the procedural hurdles to pursue derivative lawsuits and consequently weakens shareholders' litigation rights (Davis, 2008; Erickson, 2010; Appel, 2016).

We examine the effect of weakened shareholder litigation rights on the cost of debt in a difference-in-differences approach. We focus on bank loan because it is the most commonly used source of financing over the past two decades (Ivashina, 2009). Using the cost of bank loan data from 1985 to 2009, our analyses suggest that weakened shareholder litigation rights significantly increases the bank loan spreads. Specifically, the adoption of UD laws lead to a 9.4% increase in the cost of private debt.

We next conduct a battery of tests to alleviate concerns that our results are driven by omitted variables. First, we show that the average cost of debt in a state does not predict the adoption of UD laws. Second, we conduct timing tests and find that the cost of debt only increase after the adoption of UD laws and not before, indicating that firms are not anticipating the law change. Third, we rule out the effect of lobbying by documenting the effects exist among firms that incorporated in Pennsylvania, where the UD law was implemented by the state supreme court. We continue to find similar results in this subsample. Fourth, we include additional control variables and our main results remain qualitatively unchanged. Finally, we use a propensity-score-matched sample to control for underlying differences between treated and control firms. Estimation results imply that our findings are robust to controlling for observable heterogeneity.

We next explore cross-sectional variations to investigate whether the effect of UD laws varies in a theoretically predictable order. These tests serve two purposes. First, they help pin down whether the increase in the cost of debt is driven by heightened risk-taking and increased information asymmetry. Second, they further alleviate the endogeneity concerns because any omitted variable that jointly affects the adoption of UD laws and the cost of debt must be likewise correlated with cross-sectional variation. We predict and find that the effect of UD laws is more pronounced among firms that are ex ante more likely to face derivative lawsuits, measured by managerial entrenchment and the percentage of institutional investors. In addition, the effect is stronger among riskier firms that agency cost of debt is more likely to be higher.

We next examine the real effects of UD laws to further understand the underlying mechanisms that drive our main findings. Following the adoption of the UD laws, G-index, E-index, the percentage of busy directors, and captured directors all go up, suggesting that the board becomes more entrenched and internal governance deteriorates. These findings are in line with those documented in Appel (2016).[3] Second, the adoption of UD laws is associated with a significant increase in the absolute value of discretionary accruals, suggesting that managers are more likely to engage in earnings management to hide their wrongdoings. Increased information asymmetry makes it more costly for debtholders to monitor, leading to an increase in the cost of debt.[4] Third, firms increase R&D expenditures and spend more on acquisitions. Specifically, firms are more likely to engage in riskier horizontal mergers. Also, among diversified deals, firms are more likely to acquire targets whose assets have lower recovery value in default. These results indicate that the adoption of UD laws increases the cost of debt through a managerial risk-taking channel. Finally, we document a significant decrease in ROA and increase in both systematic risk and idiosyncratic risk, and a higher likelihood of becoming takeover target. Evidence also suggests that shareholders respond to weakened litigation rights by reducing managers' risk-taking incentives.

We contribute to several strands of literature. Our paper belongs to the literature that studies the effect of shareholder rights on debtholder wealth. Previous literature mostly documents that restraining the rights to govern through voice (e.g. an increased

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[2] Swanson (1992) argues that absent derivative suits, individual shareholders would have no access to compensation for injuries directly inflicted on their corporation. Therefore, the American Law Institute (ALI), sometimes called the most elite lawyers in the United States, acknowledges that "the derivative action may offer the only effective remedy in those circumstances where a control group has the ability to engage in self-dealing transactions with the corporation".

[3] Directors' busyness is detrimental to board monitoring quality and shareholder value (Shivdasani and Yermack, 1999; Fich and Shivdasani, 2006; Falato et al., 2014). The fraction of co-opted board (the board comprised of directors appointed after the CEO assumed office) is negatively related to boards' monitoring (Coles et al., 2014) and positively related to executives committing fraud (Khanna et al., 2015).

[4] See, for example, Graham et al. (2008); Derrien et al. (2016).

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