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Misrepresentation and Capital Structure: Quantifying the Impact on Corporate Security Value

Securities class actions typically involve some misrepresentation by a firm that overstates its true value. Upon misrepresentation disclosure, the observed share price drop is used to assess potential damages to shareholders. Using a capital structure model and leveraging a relationship between equity and firm value, we use observable equity information to determine firm value, including the value of other capital structure securities, and hence the effect of misrepresentation on these securities. We find that the misrepresentation impact on debt value depends on firm leverage and debt seniority. Generally, the debt for higher-leverage firms is more sensitive to the misrepresentation impact than for lower-leverage firms and junior debt is more affected by fraud than senior debt.

Our findings have important consequences for damages assessment and allocation of settlement awards in securities class actions. In some jurisdictions damages awarded are net of any hedge or risk-limitation transaction. Since corporate securities such as bonds, stocks and warrants are often held in portfolios for hedging purposes, measuring the effect of misrepresentation on all of the firm's issuances is essential to accurately computed damages awards. Additionally our approach provides a consistent methodology for computing damages for securities that do not trade on public markets. A case study of a recent securities class action illustrates our methodology.