The information content of litigation participation securities: the case of CalFed Bancorp

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Abstract

CalFed Bancorp is one of 126 S&Ls suing the U.S. government for breach of contract related to supervisory goodwill, a form of goodwill created by the acquisition of insolvent thrifts during the early 1980s. Before a determination of damages in its lawsuit, CalFed announced and issued a litigation participation security giving shareholders a proportional claim on recovered damages, if any. This announcement generated a positive excess return in part because it made CalFed a more likely acquisition target. Trading in the security also reveals important, yet previously unavailable, information about CalFed’s lawsuit: its price reveals a market-based estimate of damages while its beta reveals information regarding expected returns and trial duration. In a broader context, this paper identifies acquisition facilitation as a benefit of issuing targeted stock and

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Michael Carvin of Cooper, Carvin & Rosenthal in Washington, DC, kindly provided a list of plaintiffs.


1. Introduction

During the early 1980s, regulators encouraged healthy savings and loan associations (S&Ls or thrifts) to acquire approximately 300 failing thrifts instead of closing them and paying off their insured depositors. These acquisitions, known as supervisory mergers, created an asset on the acquirers’ balance sheets known as supervisory goodwill (SGW) which was equal to the difference between the fair market value of the acquired thrift’s assets and its liabilities under purchase accounting. According to the merger agreements, SGW could be amortized on a straight-line basis over periods of up to 40 years. Thrifts were willing to acquire failed institutions precisely because they could use SGW to meet minimum capital requirements rather than recognizing the insolvent thrift’s negative net worth at the time of the merger.

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, however, restricted thrifts’ abilities to use SGW as capital by reducing the amortization period and by creating alternative, stricter capital standards. As a result, many thrifts fell below minimum capital standards and were either closed by the regulators or forced to recapitalize. In response, a total of 126 thrifts sued the U.S. government for breach of contract related to FIRREA.²

CalFed Bancorp (CalFed), which is now part of Golden State Bancorp but was formerly one of the country’s largest S&Ls, filed its lawsuit in February 1992. The U.S. Court of Federal Claims (the Claims Court) stayed CalFed’s lawsuit and other similar lawsuits pending resolution of three test cases – Winstar, Statesman, and Glendale – filed prior to 1992.³ The test cases have proceeded in

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