

# Financial Distress, Stock Returns, and the 1978 Bankruptcy Reform Act\*

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## Abstract

We study the effect of weakening creditor rights on stock returns via a major bankruptcy reform that shifted bargaining power in distressed firms in favor of shareholders. The reform significantly reduces portfolio- and firm-level distress premia of distressed stocks. The decline in distress premia is smaller for firms with higher and with more substitutable firm-level proxies of shareholder bargaining power, which suggests a differential effect of the reform-based increase in shareholder bargaining power on stock returns. Higher corporate bond yield spreads, lower stock returns of firms with deviations from absolute priority, and higher return continuation of distressed stocks provide supporting evidence. Thus, we document an important channel how creditor rights affect the costs of external funding; while weaker creditor rights are associated with higher bond yields, they can lead to lower equity premia.

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