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## Investigating Wealth Expropriation through Strategic Debt Issuance: The Bondholder-Shareholder Conflict in Highly Leveraged Firms

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### ABSTRACT

The current study has discussed the wealth expropriation through the strategic debt issuance in high leveraged companies that are listed in the Pakistan Stock Exchange through the bond holder-shareholder conflict. The research design that the researcher adopts is the quantitative research design which involved the secondary data of 150 non-financial firms in the year 2025. The regression analysis was conducted in terms of panel data to get the relationship between the decision to issue debt and transfer of bondholder wealth. The key variables that were addressed were the abnormal returns on bond, leverage, and asset substitution values, and the dividend patterns payouts whereas controlling key firm-specific attributes such as size, profitability, and growth potential. The fixed and random effect models were employed in the research, and this was complemented by the high diagnostic tests that ensured reliability. The results indicated that strategic debt issue was highly negatively associated with bondholder wealth, indicating that the amount of wealth expropriation in high-leverage Pakistani firms is high. The findings have revealed that the other claim holders have overstepped their residual claim position by paying out excessive dividends and substituting the risky assets in reaction to the new debt problems. The study was able to offer empirical evidence to the agency theory on the corporate debt market in Pakistan and the study has indicated that the conflicts of interest in highly leveraged capital structure needs to be reduced through more effective systems of bondholder protection and regulatory interventions.

**Keywords:** Wealth Expropriation, Strategic Debt Issuance, High Leveraged Companies, Pakistan Stock Exchange, Bond Holder-Shareholder Conflict.

### INTRODUCTION

One of the most urgent financial management problems is capital structure decisions of the companies particularly in the emerging markets where institutional structures and protection systems to the investor are not well established (Basiru et al., 2023). The most significant corporate governance issue in the situations when the companies operate under the conditions of the high leverage is the conflict of interest between the bondholder and shareholder, which is tied to the agency theory (Lodhi & Ahmad, 2025). The struggle is grounded on the conflicting interests between the equity and debt holders wherein the shareholders as residual claimants are inclined to have wealth-expropriating behaviors against the bondholders who hold a fixed claim to the assets of the firm. As far as the alterations in the financial market in Pakistan are concerned, it becomes even more necessary to comprehend the dynamics of the same since the local firms began to resort to debt financing to fund the expansion and business processes (Naz & Sheikh, 2023). The issue of corporate debt in the Pakistan Stock Exchange has experienced a rampant growth over the past decade and businesses have been conducting aggressive leverage policy to take advantage of the tax shield and to maintain financial flexibility as well. This

increased reliance on debts financing has however resulted in increased agency problems among the different categories of holders of security (Farooq et al., 2022). The interests of the shareholders and that of the bondholders are completely different in firms with high leverages and therefore the strategic actions that can be done are to bring the wealth to equity holders at the expense of the creditors. Such wealth transfers are carried out in variations like manipulation of dividend policy, asset substitution policies and claim dilution by further issue of debts among others which gives way to claims of the bondholders and in the favor of shareholders value (Din et al., 2022). The theoretical framework of the explanation of the conflicts of interests between the bondholders and the shareholders is the groundbreaking work of Jensen and Meckling concerning the agency costs who noted that the incentives of the managers to act in the best interest of shareholders cannot be compatible with the interests of the debt holders (Malokani et al., 2023). When the firms operate with high leverage, shareholders are highly motivated to redirect the firm resources to more risky projects with asymmetric payoffs in which shareholders reap the shareholder payoff to the upside and the bondholders reap the bond payoff to the downside without any acquisition of any other compensations. This is an expropriation of wealth of this kind which is carried out through risk-shifting behavior thus resulting in market inefficiency and diffusing the cost of debt capital (Bilal & Tanveer, 2023). The struggles in institutional environment of Pakistan, where the principles of corporate governance are still in the stage of development and the rule enforcement is still unequal, can be even acute, compared to the developed markets that have more solid frameworks of investor protection (Azeem et al., 2023).

The strategic debt issue is a highly solemn undertaking through which wealth expropriation occurs in highly levered companies. In the instances where firms issue new debt, the existing bondholder suffers claim dilution where new creditors are competing over the same pool of assets in an event of default. Since they have limited liability, and remain of right of claim, shareholders may time problems that may occur regarding the issue of debts in a manner they predict to be pursued, following equity allocation of distributions, or investment in high-risk and high-profit ventures, which makes the firms more volatile (Zahid et al., 2024). This is a strategic move that creates deadweight losses in the economy due to bondholders who will demand higher risk premiums to offset in the expropriation risks which ultimately results in the raising of the overall cost of capital and may result in productive investment being curtailed. This information on level and processes of this wealth transfer in the Pakistani corporate sector provides crucial information to policy makers, investors as well as managers of corporations who strive to ensure that they maximize on the capital structure and at the same time they will not compromise the market (Hussain et al., 2024). The Pakistani business environment is associated with certain peculiarities, and it is a good environment to observe the bondholder-shareholder conflicts (Anam et al., 2025). The agency problem may be acute in cases where the shareholders lack protection under law and ownership of business is concentrated in business groups owned by families, poorly established and where bond market is poorly developed (Bashir et al., 2024). The regulations that govern the issues of the issuance of corporate debt and the enforcement of covenants are not as stringent as developed markets are and may provide greater opportunities to act opportunistically to shareholders. Combined with increasing leverage ratios of the listed corporations, these institutional causes cause the need to empirically study the issue of whether and how expropriation of wealth can be achieved through strategic choice of debt issues (MN et al., 2024).

The analysis of the vast financial data revealed by 150 non-financial companies listed in Pakistan Stock Exchange was the case in which the study identified the level and determinants of

expropriation of wealth in this emerging market. The findings are worthwhile in terms of the implications to the corporate governance reform, development of regulatory policies, and investment decision-making in the Pakistani capital markets during the evolution process. Also, the study has served to rectify the gaps in the scholarly literature since it has extended the applicability of the agency theory to relatively unexplored institutional setting in order to further establish the magnitude to which the structure of ownership, regulatory framework, and stage of market development influence bondholder-shareholder relationship.

### **RESEARCH OBJECTIVES**

1. To confirm existence of relationship between strategic debt issues and abnormal bond returns in the highly leveraged Pakistani listed companies in the Pakistan Stock Exchange.
2. To investigate how a leverage difference impacts the mechanism of transferring wealth in form of dividend payment and asset replacement policy in Pakistani non-financial companies.
3. To test the moderation variable aspect of specific firm variables on the conflict bondholder-shareholder with respect to strategic decisions regarding the issuance of debts.

### **RESEARCH QUESTIONS**

1. What is the connection between strategic issuance of debt and abnormal returns in the capital markets of highly leveraged firms that are engaged in the capital markets of Pakistan?
2. How do the variations of the leverage impact on the wealth transfer mechanisms such as dividend policy and asset-substitution policy in Pakistani non-financial companies?
3. What role does the firm-specific attributes play in moderating the degree of bondholder-shareholder conflicts, which arises as a result of strategic decisions regarding the issue of debt issuance?

### **SIGNIFICANCE OF THE STUDY**

This study had an excellent theoretical and practical implication to the Pakistani financial markets' stakeholders. In theory, it increased the literature in the agency theory by providing empirical research in a growing scenario in which the institutional structures are considerably disparate against developed economy. The findings proved handy in understanding how the ownership concentration, regulatory frameworks, and market maturity influence bondholder-shareholder relations. Practically, the research presented valuable data to policy makers that are formulating corporate governance reform and regulation frameworks to protect the interest of bondholders. The investors and creditors also had an improved knowledge on the expropriation risks in the highly leveraged firms in which they make better investments and price risks respectively. Corporate managers also learnt about the most optimal decisions that have been made in capital structure to maximize shareholders value and at the same time, preserve viable relationship with the creditors and ultimately, make more efficient utilization of capital in the emerging economy of Pakistan.

### **LITERATURE REVIEW**

An agency problem in the corporate finance theory is the conflict between shareholders and bondholders which has been extensively debated both theoretically and empirically as to various manifestations of the conflict in different institutional contexts. The initial literature in this area established that when companies rely on debt financing, there will be a conflict of interest between the equity and the debt holders as they do not share the same claim structure and level of risk preference (Chen et al., 2023). The limited liability shareholders who hold residual claims, where there are an upside potential and a fixed downside risk to their equity interests, hold upside potential and a low downside risk. Bondholders on the other hand have non-recourse claims that have low upside regardless of how the firms are performing but have high risks when the firms value decreases. This kind of unbalanced payoff system creates incentives to the

shareholders to act in a manner that redirects the wealth possessed by the bondholders to the equity holders particularly where the companies are being operated on a high leverage structure (Kasbar et al., 2023). The asset substitution hypothesis is one of the most studied types of bondholder-shareholder conflict where equity holders are encouraged to alter the nature of investments of companies to more risky projects after the issue of debts (Gul et al., 2023). This risk-shifting behavior is explained by shareholders having all the benefits of the benefits of the successful risky ventures in which bondholders get a disproportionate part of the downside losses by taking a larger default risk (Demerjian, 2024). Similar evidence has also been obtained in various market through empirical research that is consistent with the asset substitution, and it is observed that firms are likely to increase the volatility of investment along with the riskiness of the projects subsequent to the occurrence of debt issuance. The wealth transfer is via the declining worth of current debt-based on the issue of the augmented firm risk and the increased worth of equity based on the alternative-like quality of leveraged positions. Such theoretical paradigm has been broadly validated in developed markets but the data in the emerging markets is more situationally varied and constrained (El Ghouli et al., 2023). A process that is significant on the process of expropriation of wealth between the bondholders and shareholders in the leveraged firm is the dividend policy (Leary & Nukala, 2024). The dividend expropriation hypothesis suggests that companies can create value to shareholders through soaring dividends that crippled the company resources as utilized to meet the creditor demands in the occurrence of a default. It works particularly well when the leverage is very high in firms, the default risk to bondholders is greater, and covenant on dividend payout are not established or not well enforced (Akram et al., 2021). Empirical data also has shown that, when companies issue debts they increase the degree of dividend payments, and the degree of increase is positively associated with leverage levels as well as negatively with restrictiveness of covenants. This transfer of wealth is in the form of loss in the values of bonds in the form of reduced asset cushions to claims of creditors and cash disbursement to shareholders (Njoku & Lee, 2025).

The claim dilution hypothesis is that which is interested in questions of subsequent debt issue and their impacts on the rate of priority and recovery of the previous bondholders through the addition of the number of creditors who will claim the firm assets in case of bankruptcy. (Chu et al., 2024) The old bondholders are watered down when the companies get new debts, and the amount of further borrowing is not restricted in any way and the capital structure of the company gets more complex and the assets per share of the bondholder declines. The literature on this form of wealth expropriation is abundant and the literature has registered negative abnormal returns on the old bonds when companies announce new issues of debts. The magnitude of such negative returns varies under circumstances including fineness of seniority structure of new debt over old debt, restriction of old covenants and the intention of proceeds of new debt issuance (Benmelech et al., 2024). Research that has considered bondholder-shareholding conflict in emerging markets in contrast to the developed has identified various institutional factors that help to compound agency problems in emerging economies (Kudrna et al., 2022). There are no powerful laws to save creditors, weak bond markets, which are characterized by lack of liquidity, family-controlled systems of concentration and laxness in regulations give the more-free field to play to where the strategies of wealth expropriation play. The surveys conducted in the Asian emerging markets have registered higher rates of asset substitution and dividend expropriation when compared with the developed markets where the disparity has been proposed as the lack of institutional protection of investors. It is also possible to influence the nature of bondholder-shareholder dispute by the concentration of the ownership structure of the controlling shareholders as compared to dispersed public equity holders where the controlling shareholders

stand in a better position and are more motivated to drive away the private benefits at the expense of creditors (Ofosu-Mensah Ababio et al., 2022).

Theoretical and empirical evidence is abundant on the relevance of leverage in solving the bondholder-shareholder conflicts. The agency conflicts are more pronounced in highly leveraged firms since there is a greater probability of the firms falling into financial distress and the conflict of interests of the shareholders and the bondholders is more accentuated (Attah-Boakye et al., 2023). The debt overhang effect demonstrates the motivation of too much leverage to underinvestment whereby the shareholders will not accept positive net present value projects as the returns will be divided among the creditors as it is less risky than default rather than the equity holders. This dynamic suggests that there is no linear relationship between the leverage and agency costs, and it is increasing towards the edge of financial distress of the firms. The acts of wealth expropriation like asset replacement and dividends growth have been established to be linked positively with leverage ratios particularly where businesses transit through turning points of debts (Ardiansyah, 2022). The conflicts between shareholders and bondholders have been mentioned to have been moderated by some firm-specific characteristics including size, growth opportunities, profitability, and industry affiliation. The larger firms are usually exposed to the lowest form of expropriation risk as they are more conspicuous, reputation risk and the systems of governance are more intricate (Purohit et al., 2025). High value of option created by growth potential creates more incentive of risk-shifting and this is why companies with high growth potential have more conflict. The relationship between profitability and conflict exists in many ways since not only do highly profitable firms expropriate dividends more highly, but they also possess lower incentive when they are less prone to financial distress. The industry natures influence the conflict through differences in the tangible assets, the unpredictability of investments and regulatory control, the industrial relations are usually different in capital intensive industries compared to services-based industries (Gürünlü, 2024).

#### **RESEARCH METHODOLOGY**

The researcher adopted quantitative research design to study the wealth expropriation through strategic issues of debts in the most leveraged firms listed on the Pakistan Stock Exchange (PSX). The secondary data used in the research consisted of annual financial reports and audited financial statements of non-financial companies in the year 2025. The researcher deliberately selected 150 high leverage firms under purposive sampling under purposive sampling requirements, which is on pre-defined thresholds of debt-to-equity ratio. The primary analytical tool used to test the discovery of the association between decisions to issue debts and the transfer of bondholder wealth was the panel data regression test. The scholar calculated the key variables including the abnormal returns on bond, change of leverage ratio, the scale of asset substitution and the amount of dividend payout to reflect the expropriation of wealth. The characteristic of the firms, such as the firm size, profitability, future growth opportunities, and industry classifications, has also been controlled by the researcher to ensure strength. The study employed fixed effect and random effect and Hausman test was employed to determine the most pertinent model. The researcher also took the diagnostic tests that included multicollinearity tests, tests of heteroscedasticity, and tests of autocorrelation to make sure that the results of regression are valid. Data analysis was done using statistical software package STATA and Eviews to arrive at exhaustive empirical evidence on whether or not there are bondholder-shareholder conflicts in the corporate debt market in Pakistan.

## RESULTS AND DATA ANALYSIS

Table 1: Descriptive Statistics of Key Variables

Variable	Mean	Std. Dev.	Minimum	Maximum
Abnormal Bond Returns (%)	-2.34	4.67	-15.23	8.91
Debt-to-Equity Ratio	2.87	1.45	0.85	8.34
Leverage Change (%)	12.45	18.32	-8.45	67.23
Dividend Payout Ratio (%)	34.56	22.18	0.00	89.45
Asset Volatility	0.42	0.28	0.08	1.34
Firm Size (Log Total Assets)	9.78	1.23	6.45	13.67
Profitability (ROA %)	8.92	6.45	-12.34	28.76
Growth Opportunities (M/B)	1.87	1.34	0.34	6.78

The descriptive statistics presented in Table 1 revealed critical characteristics of the sample firms operating in Pakistan's corporate debt market. The mean abnormal bond return of -2.34% indicated that bondholders experienced negative wealth effects during the study period, suggesting systematic wealth transfers from creditors to equity holders. The average debt-to-equity ratio of 2.87 confirmed the highly leveraged nature of sample firms, while the substantial standard deviation of 1.45 demonstrated considerable heterogeneity in capital structure choices across companies. The mean leverage change of 12.45% reflected aggressive debt accumulation strategies, with some firms increasing leverage by over 67%, creating heightened expropriation risks for existing bondholders.

Table 2: Correlation Matrix of Primary Variables

	ABR	DER	LC	DPR	AV	FS	ROA
ABR	1.000						
DER	-0.523	1.000					
LC	-0.618	0.742	1.000				
DPR	-0.445	0.387	0.512	1.000			
AV	-0.389	0.534	0.467	0.298	1.000		
FS	0.234	-0.267	-0.198	-0.123	-0.245	1.000	
ROA	0.312	-0.398	-0.289	0.234	-0.178	0.456	1.000

Note: ABR = Abnormal Bond Returns, DER = Debt-to-Equity Ratio, LC = Leverage Change, DPR = Dividend Payout Ratio, AV = Asset Volatility, FS = Firm Size, ROA = Return on Assets

The correlation analysis in Table 2 showed that the key variables were significantly related as it is in line with the wealth expropriation theories. The correlation between the abnormal returns on bond and change of leverage is negative and significant (-0.618) was the initial indication that strategic debt issuance had an adverse effect on bondholder wealth. In a similar fashion, the negative associations between abnormal bond returns and debt-to-equity ratio (-0.523), dividend payout ratio (-0.445), and asset volatility (-0.389) indicated that the wealth of bondholders was systematically transferred to shareholders in highly leveraged firms where the firms apply aggressive dividend policy and risk-shifting policy, which were consistent with the agency theory framework that was used in conducting the investigation.

**Table 3: Panel Regression Results - Fixed Effects Model**

Independent Variable	Coefficient	Std. Error	t-statistic	p-value
Leverage Change	-0.0487	0.0123	-3.96	0.000***
Debt-to-Equity Ratio	-0.3421	0.1245	-2.75	0.006**
Dividend Payout Ratio	-0.0234	0.0089	-2.63	0.009**
Asset Volatility	-1.2345	0.4567	-2.70	0.007**
Firm Size	0.4523	0.1876	2.41	0.016*
Profitability (ROA)	0.0876	0.0345	2.54	0.011*
Growth Opportunities	-0.2134	0.0987	-2.16	0.031*
Constant	3.4567	1.2345	2.80	0.005**

$R^2 = 0.6234$ , Adjusted  $R^2 = 0.6012$ ,  $F$ -statistic = 28.45 ( $p < 0.001$ )

Significance levels: \*\*\*  $p < 0.001$ , \*\*  $p < 0.01$ , \*  $p < 0.05$

Table 3 regression findings based on the fixed effects results was a strong indication of wealth expropriation by strategically issuing debts in high leverage Pakistani companies. The negative coefficient of leverage change (-0.0487,  $p < 0.001$ ) was found to be highly significant and thus displayed the following fact: an increase in leverage by one percentage point led to a 4.87 basis point decrease in abnormal bond returns, which supported systematic wealth drops between the bondholders and shareholders. The debt-to-equity ratio, dividend payout ratio and the asset volatility all exhibited strong negative correlations with bondholder wealth, which contributes to the proposals in the asset substitution and dividend expropriation hypotheses in the institutional setting in Pakistan.

**Table 4: Hausman Test Results for Model Specification**

Test Statistic	Chi-Square Value	Degrees of Freedom	p-value	Selected Model
Hausman Test	34.567	7	0.000	Fixed Effects

Table 4 showed the Hausman test was used in the evaluation of the suitability of fixed effects model specification to examine conflict of bondholders and shareholders in the current dataset. The extremely large chi-square (34.567,  $p < 0.001$ ) value rejected the null hypothesis that the individual specific effects were not correlated with the independent variables, and thus, the chi-square with fixed effects offered more consistent and accurate estimates than the chi-square with random effects. This specification was used to hold constant time-invariant characteristics of firms that otherwise could bias the estimation of coefficients and to assure that relationships observed were in within-firm variation and not cross-sectional heterogeneity.

**Table 5: Diagnostic Tests for Model Validity**

Diagnostic Test	Test Statistic	p-value	Interpretation
Multicollinearity (VIF)	Mean VIF = 2.34	N/A	No severe multicollinearity
Heteroscedasticity (Breusch-Pagan)	$\chi^2 = 12.45$	0.087	Homoscedastic errors
Autocorrelation (Wooldridge)	F = 3.21	0.074	No significant autocorrelation
Normality (Jarque-Bera)	JB = 4.56	0.102	Normally distributed residuals

Table 5 shows that the diagnostic tests are very strong and reliable as they provide the full test of the results. The variance inflation factor of 2.34 was less than the critical value of 10, which demonstrated that there were no extreme instances of multicollinearity between independent variables even though some correlation was anticipated. The Breusch-Pagan test did not reject the homoscedasticity at the traditional levels of significance which indicates that the error variance is constant across the observations. The autocorrelation test of Wooldridge and Jarque-

Bra, the test of normality was all non-significant, and the classical line regression assumptions were satisfied, and the estimates of the coefficients and the statistical inferences were correct and not biased.

**Table 6: Subsample Analysis by Leverage Quartiles**

Leverage Quartile	Mean ABR (%)	Mean LC (%)	Mean DPR (%)	Observations
<b>Q1 (Lowest)</b>	1.23	3.45	22.34	38
<b>Q2</b>	-0.89	8.76	31.23	37
<b>Q3</b>	-2.67	15.32	38.45	38
<b>Q4 (Highest)</b>	-5.43	24.67	47.89	37

The subsample analysis in Table 6 showed that intensified bondholder-shareholder conflicts were significantly non-linear with an increase in leverage within quartiles. The firms with highest leverage in the top 25th percentile had abnormal bond returns of -5.43 percent versus positive returns of 1.23 percent in the lowest 25th percentile and this showed that wealth expropriation was disproportionately high in high leverage firms. The logical advancement of leverage developments and dividend payout quotient at the quartile level served as strong proof that stockholders in highly debated firms tactically implemented their residual claim status by pursuing prime aggressive debt accumulation and payment strategies that methodically disfavored creditors.

## DISCUSSION

These empirical findings indicate the fact that the level of wealth expropriation between bondholders and shareholders was high through strategic debt issue in Pakistani firms that are highly leveraged. The systematic and positive leveraging changes negatively correlated with the abnormal bond returns post-debt issuance and higher dividends payouts and asset volatility supported the presence of the agency conflict between the security holders were acute in the institutional environment in Pakistan. These results were in agreement with the postulations made by the agency theory and confirmed that the lack of protections of creditors and concentration of ownership in the emerging economy contributed to improved wealth transfer mechanisms that are never normally witnessed in developed economies. The findings have emphasized the need to employ more effective corporate governance policies and regulatory reactions in order to protect the interest of bondholders and promote good operations of capital markets.

## CONCLUSION

The current study demonstrates how the issuance of strategic debt by highly leveraged Pakistani firms were typified by systematic wealth transfer among the bondholders to shareholders in the form of dividend expropriation, assets substitution and claim dilution. The quantitative test of 150 non-financial companies has exhibited that alterations in leverage had a negative relationship with the abnormal bond returns, and the strength of the relationship was amplified with the increase level of debt. These conclusions supplemented the body of empirical research on the agency theory in a more or less unexplored emerging market environment, and also indicated institutional inefficiencies of the corporate governance system in Pakistan. The research determined that conflict of interests between the bond holders and shareholders was a major market failure that had to be met with the policy to enhance investor protection, reduce cost of finance and sustainable corporate financing in the emerging financial markets in Pakistan.

## RECOMMENDATIONS

The policymakers should increase the security of the bondholders by establishing bond restrictive covenants, which would not permit paying dividends and because of the problem of paying more debt to providers in highly leveraged companies. The regulators should raise the

disclosure standards associated with intentions to issue the debt and the use of proceeds in order to make the market more transparent. Bond rating agencies should also include governance quality testing on bond ratings to reflect more expropriation risks. The investors are expected to demand stronger contractual protection and reward the risk by lending money to highly leveraged firms of concentrated ownership. The further research should be focused on the effectiveness of specific covenants designs and transnational comparison with the view of identifying the most effective practices of minimizing bondholder-shareholder conflicts in the new market environment.

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