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Corporate distress and lobbying: Evidence from the Stimulus Act[☆]

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ABSTRACT

The literature on distressed firms has focused on these firms' investment, capital structure, and labor decisions. This paper investigates a novel aspect of firm behavior in distress: how financial health affects a firm's lobbying and, consequently, its relationship with the government. We exploit the shock to nonfinancial firms during the 2008 financial crisis and the availability of the stimulus package in the first quarter of 2009. We find that firms with weaker financial health, as measured by credit default swap spreads, lobbied more. We also show that the amount spent on lobbying was associated with a greater likelihood of receiving stimulus funds.

1. Introduction

Firms in distress often engage in risky investments to benefit equity holders at the expense of debt holders, dismiss the top management, or are forced to sell productive assets. In the context of large banks, previous work has highlighted the role of government in providing bailouts and resolving distress.[1] In this paper, we consider how the financial health of nonfinancial firms affects their relationship with the government through lobbying. We ask in particular whether deteriorating financial health leads nonfinancial firms to lobby the government more, especially when large sums, as provided by the Stimulus Act, are available.

Government bailouts—the focus of the discussion around large financial firms—are not the only reason for firms to

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[1] See, e.g., Jensen and Meckling (1976), Eisdorfer (2008), Rauh (2009), and Gilje (2013) for a discussion of risk shifting; Gilson (1989), Kaplan and Minton (1994), Hotchkiss (1995), and Farrell and Whidbee (2003) for evidence on dismissal of top management; Asquith, Gertner, and Scharfstein (1994) on the disposal of productive assets; and O'Hara and Shaw (1990), Gorton and Huang (2004), Brown and Dinc (2005), Duchin and Sosyura (2012), Acharya, Drechsler, and Schnabl (forthcoming), Blau, Brough, and Thomas (2013), and Philippon and Schnabl (2013) for the literature on bank bailouts. Laeven (2011) provides a survey of the causes and consequences of banking crises.

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lobby. Companies can also lobby for favorable legal treatment and for new government contracts.[2] It is, however, not ex ante clear that weaker firms would lobby the government more than stronger firms. Financially stronger firms may have better access to members of Congress or lobby more if the returns from legal or regulatory changes are captured mostly in the long run. Similarly, some government contracts may be available only to firms that are likely to continue operating for many years. On the other hand, distressed firms may lobby more than healthier firms if the government is a more willing customer when private demand is low. This paper aims to disentangle these effects.

We study the role of financial health on a firm's efforts to influence the government through lobbying in the period leading up to and during the 2007–2009 financial crisis. We adopt a difference-in-differences framework to compare the lobbying efforts of nonfinancial firms before and after the 2008 financial crisis and relate these efforts to their (changing) financial health. We use these firms' credit default swap (CDS) spreads as our measure of firm financial health, as this is both timelier and more informative than accounting measures that could be constructed. Given the nature of the crisis, the change in the financial health of nonfinancial firms during this period is likely to be exogenous to the pre-crisis lobbying by these firms and other unobserved factors that would affect both lobbying efforts and firm distress in normal times.

We find that weaker firms spend more on lobbying and are more likely to cite the Stimulus Act—the American Recovery and Reinvestment Act of 2009—among the issues they lobby for. This result is robust to controlling for such firm-specific variables as size, profitability, market-to-book, all the firm characteristics that remain unchanged during the short window before and during the passage of the stimulus bill, industry-wide time trends, state-level trends, and the adoption of different time windows for comparison in the difference-in-differences framework. Similar results are obtained in an industry-level analysis: industries with lower (value-weighted) average returns lobbied more during the passage of the Stimulus Act. Interestingly, and consistent with previous work on the crisis (e.g., Almeida, Campello, Laranjeira, and Weisbenner, 2012), weaker firms decreased their capital investments in that period while increasing their spending on lobbying. This suggests a shift from productive economic activities to rent-seeking activities as a firm's financial health deteriorates. As argued by Krueger (1974) and Murphy, Shleifer, and Vishny (1991, 1993), among others,[3] such rent seeking is costly to the economy. These costs have not previously been highlighted in the financial distress literature, and they are unlikely to be captured in pure financial cost estimates because the whole economy rather than the firm itself bears much of the costs of rent seeking.[4]

This paper also provides evidence that lobbying activities seem to be fruitful for firms. We find that companies that lobbied more were subsequently more likely to be direct recipients of stimulus funds, officially termed "prime recipients." They also received larger dollar amounts. Interestingly, this is not a reflection of firm financial health. When the analysis controls for the amount spent on lobbying, firm financial health has no effect on the disbursement of stimulus funds. In other words, firms that lobbied, not financially weak firms per se, were more likely to receive stimulus funds. These results are robust to controlling for size and industry. To our knowledge, our paper is the first that relates lobbying to the disbursement of the stimulus funds.

Our focus on lobbying and on this time frame has several advantages. Based on the sums spent, lobbying seems to be the main way through which corporations participate in politics.[5] For example, the amount spent on lobbying by US corporations in the 2007–2008 cycle was over $6 billion, while the amount firms spent on campaign contributions in the same election cycle (which included a presidential election) was just under $700 million.[6] Also, during 2007–2008, the United States entered one of the deepest and longest recessions in its history and, partly as a response, Congress passed a series of spending measures meant to stimulate the economy. The total package approached $800 billion, of which over $200 billion was allocated to federal grants. Hence, in this period, there were both many firms with deteriorating financial conditions and large sums of government money spent in a fairly short time. Lobbying during this period could potentially influence not just the passage or the size of the stimulus package but, perhaps more important, its division among spending categories. From the government's perspective, the main goal was to provide funds to the private sector to increase investment and consumption, so it is likely that the division of funds among sectors was more subject to influence by outsiders. All of these factors make this period an ideal setting for a study like ours.

Unlike the large literature on government rescues and the recapitalization of weak banks, we focus on the actions taken by weak nonfinancial firms—typically much less regulated than banks—to influence the government. In a related paper, Faccio, Masulis, and McConnell (2006) study the role of political connections in the likelihood of government rescues around the world. Many papers also

[2] There is a large literature on government interventions and bailouts of failing banks. We study nonfinancial firms and focus on the actions of firms with weakening financial health, not the actions of the government. We discuss this literature in more detail below.

[3] Dejardin (2011) provides a recent survey on rent seeking.

[4] For the direct and indirect costs of firm distress as they relate to firm capital structure choice, see, e.g., Gruber and Warner (1977), Andrade and Kaplan (1998), Graham (2000), Almeida and Philippon (2007), and Elkamhi, Ericsson, and Parsons (2012).

[5] Given the relative size of lobbying and corporate campaign contributions, previous literature has suggested that lobbying is the main way through which corporations influence US politics (Ansolabehere, De Figueiredo, and Snyder, 2003; Wright, 1990), but evidence also suggests that campaign contributions may have an impact on company stock returns (Cooper, Gulen, and Ovtchinnikov, 2010). There are also other margins that corporations may use to influence government, including appointing politically connected boards; see, e.g., Fisman (2001), Faccio, Masulis, and McConnell (2006), and Goldman, Rocholl, and So (2009, 2013).

[6] All the data on campaign contributions and lobbying are from mandatory disclosure reports and are provided by the Center for Responsive Politics (www.opensecrets.org), as explained in the data section.