



The disciplinary effects of non-debt liabilities: Evidence from asbestos litigation



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ABSTRACT

I study firms with past asbestos ties that suffer from significant increases in legal liabilities after a U.S. Supreme Court ruling in 1999. This event provides a natural experiment setting to estimate the indirect effects of financial distress on real activities. While direct litigation and bankruptcy costs are significant, value computations and clinical evidence at the operational level show that defendant firms suffer only minor indirect costs of financial distress. Furthermore, these firms actively restructure and refocus on core operations during distress. Overall, my results provide support for potentially significant disciplinary effects of non-debt liabilities.

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1. Introduction

Financial distress is often considered one of the most important frictions associated with debt. For instance, excess leverage is thought to affect operating performance by worsening the competitive position of the firm and disrupting the firm's relationship with its suppliers, key employees and customers (see, for instance, Bolton and Scharfstein, 1990; Parsons and Titman, 2008). Conversely, leverage can also carry some benefits. With an all-equity firm, management can become complacent and destroy firm value over time; especially if it is generating large free cash flows over which it has significant discretion (Jensen, 1986; Wruck, 1990). The debt monitoring hypothesis put forward by Jensen and Meckling (1976), Grossman and Hart (1982) and Jensen (1986) suggests that liabilities can add value by playing a disciplinary role on management's actions.

The most significant challenge when estimating the effects of financial distress is identification. That is because financial distress is typically an internally driven event caused by poor operating performance. In those circumstances, Wruck (1990) notes that "it is impossible to tell whether the loss in profits is in fact caused by financial distress or whether financial distress is caused by the loss in profits." The main contribution of this study is to analyze the costs and benefits of financial distress induced by significant *non-debt* liabilities that are unrelated to current operations. More specifically, I use a natural experiment whereby firms with past asbestos use suffer from a material increase in their legal liabilities following a U.S. Supreme Court decision in Ortiz (1999). Because the financial distress is caused by an unexpected surge in legal liabilities unrelated to the defendants' current operations, this study provides a unique opportunity to analyze the impact of financial distress on firms' real activities.¹

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¹ In sharp contrast, tobacco litigation also affects the defendant firms' product market as the tobacco industry still produces the litigious goods (Dahiya and Yermack, 2003).

Using accounting disclosure rules, I find 270 public corporations exposed to asbestos litigation in the U.S. over the 1999–2006 period. For each firm, I first determine the direct cost of litigation. Then, I gauge the level of financial constraints imposed by the litigation similarly to Kaplan and Zingales (1997). Because I aim to gauge the causal effects of financial distress on real activities, I also control for any confounding deterioration in the firms' underlying product markets.

A great majority of firms are shielded by their liability insurance coverage and suffer only immaterial legal expenditures. From the detailed analysis of legal and financial exposure of all asbestos defendants, I find 15 firms that are in financial distress due to their rapidly increasing legal liabilities following the Supreme Court decision. These firms have positive operating margins at the onset of distress; confirming that the severe weakening of their financials is not related to their underlying product markets. As such, these asbestos-tainted firms provide a unique laboratory to study the effects of excess liabilities on real operations.

The direct costs of litigation are large for these firms and often run in the billions of dollars. Furthermore, the so-called direct costs of bankruptcy, which include professional fees, average almost 8% of pre-distress firm value. These direct costs are high relative to the extant literature (Weiss, 1990) and can be explained by the protracted negotiations in Chapter 11 that extend the time in bankruptcy for these firms to more than five years on average.

Following Andrade and Kaplan's (1998) methodology, I perform value computations to estimate the net *indirect* effects of financial distress. Controlling for the direct litigation and bankruptcy costs, the estimated net indirect effects of non-debt liabilities on firm value correspond to a median *gain* of 5% to 35% of pre-distress firm value depending on the specification used. Given the small sample size of this study, statistical significance is somewhat weak. However, these computations suggest that non-debt liabilities do not appear to lead to any significant additional losses in terms of firm value.

To assess further the potential spillover effects of financial distress, I perform a detailed analysis at the operational level from the pre-crisis year to the resolution year. Throughout the quantitative analysis, I compare the defendant firms with two different matched samples based on industry, size and profitability.

In terms of operating margins, I document a mildly statistically significant decline at the onset of distress compared to the industry size matched control group. It is followed by a recovery whereby, at the year of resolution, operating margins of the median firm are back to their pre-distress levels and not statistically different from those of the peer group. This recovery is explained in part by better productivity and cost cutting. In particular, defendant firms manage to significantly decrease their average Sales, General and Administrative expenses (SG&A) to total assets by about 25% over the crisis period.

In terms of discretionary spending, capital expenditures (CAPEX) drop over the sample period and defendant firms reduce dramatically their M&A activity during the distress period. The defendant firms are actively acquiring over the three years prior to the onset of distress, with an average acquisition value equal to 6% of total assets. However, their acquisition activity comes to a complete halt during the first three years of distress. The pre-post differences are statistically and economically significant. This result is consistent with Maloney et al. (1993) who relate increased leverage with a more disciplined approach to acquisitions.

These results are generally supported by the qualitative analysis of the defendant firms' actions during the distress period. With respect to potential costs of financial distress, five firms explicitly mention CAPEX curtailments to save costs during the crisis and, four more report *temporary* cutbacks by limiting CAPEX to essential projects around the onset of distress or shortly thereafter. The fact that valuations recovered over the distress period suggests that the impact of these cuts was either temporary or compensated by other actions taken during distress. Evidence of fire sales is limited: Four firms sold some non-core assets at a loss during the distress period. I do not find any evidence of risk-shifting behavior among the distressed firms. In contrast, I find widespread evidence of operational improvements during the distress period. Almost all firms take this opportunity to shed non-core assets and significantly restructure current operations. In terms of management, more than half of the firms' top management is replaced, often during the onset of crisis year. The turnover rate is much higher than the average annual turnover of 16.9% found by Kaplan and Minton (2012).

Wruck (1990) argues that financial distress can provide the necessary impetus for management and the board to improve operations. Because most defendant firms have the capacity to generate high levels of free cash flow (Jensen, 1986) and show prior signs of relatively weak internal governance mechanisms, the effect of increased non-debt liabilities can be viewed similarly to that of the disciplinary effects induced by leveraged management buyouts (LBOs) or leveraged recapitalizations (see Kaplan, 1989; Wruck, 1994).² With the caveat that my results are derived from a small sample, the clinical evidence provided in this study shows that the disciplinary effect of liabilities can, at least partially, counteract the costs associated with financial distress.

The extant literature looking at the impact of financial distress on firm performance is large (e.g. Opler and Titman, 1994; Kalay et al., 2007). However, the estimation of indirect effects of financial distress is typically clouded by endogeneity concerns. The two most closely related studies are Cutler and Summers (1988) and Andrade and Kaplan (1998). Cutler and Summers (1988) study the Texaco–Pennzoil litigation and find that the joint market value loss exceeds the litigation costs; consistent with significant indirect costs of financial distress. However, their evidence is drawn from only one case study and they do not find any supportive evidence at the operational level. Andrade and Kaplan (1998) use a small set of Highly Leveraged Transactions (HLT) to detect “pure” financial distress and, consistent with the results in this study, find low to insignificant indirect costs of financial distress. However, endogeneity concerns still remain in their setting given that firms *choose* a highly leveraged capital structure just prior to distress. By highlighting the disciplinary effect induced by

² A contemporaneous study also uses asbestos litigation to analyze intra-industry competition and financial strength (Hadlock and Sonti, 2012). Their paper is an event study focusing on the defendants' competitors. They find that the stock value of competitors falls at the announcement of defendant firms' large legal liabilities and argue that this result is consistent with increased fixed liabilities leading to more aggressive competitive interactions. Their evidence is, however, also consistent with a market reassessment of the probability that firms within the same industry will also be caught into the sprawling litigation.

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