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Bankruptcy spillover effects on strategic alliance partners ☆

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ABSTRACT

This paper examines whether a party to a strategic alliance or joint venture suffers from spillover effects when the other partner files for bankruptcy. We find that the non-bankrupt strategic alliance partners, on average, experience a negative stock price reaction around their partner firm's bankruptcy filing announcement. This negative effect is strongest for longer partnerships and those with higher returns at the announcement of the initial alliance formation. Furthermore, horizontal alliance firms in declining industries have lower returns, indicating that industry conditions can exacerbate expected problems for the non-bankrupt firm. Non-bankrupt partners also experience drops in profit margins and investment levels in the subsequent two years with the worst performance concentrated among the longer-term agreements. There is very little impact on the returns or performance for joint venture partners, which suggests that these agreements are more insulating for the partner firm.

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1. Introduction

Long-term collaborative partnerships between two firms, such as strategic alliances and joint ventures, provide alternative contracting arrangements to simple one-off market transactions or complete integration. A key feature of these contracts is the timing and nature of the termination of the agreement. Partnerships are typically designed to last for a set number of years or until the parties reach a specified goal. Some contracts also contain early termination rights that allow one or both parties to walk away from the agreement in certain contingencies. These circumstances can be specific, such as change in control provisions, or vague, such as uncured breach (Robinson and Stuart, 2007). The intentionally incomplete nature of these early termination clauses provides a role for ex post litigation as a contracting tool that increases the overall surplus of the partnership (Scott and Triantis, 2006). These rights are valuable for the holder because they allow the firm to terminate the agreement when the perceived costs of continuing the partnership outweigh the gains.

Bankruptcy, which can impair the filing party's ability to maintain its end of the agreement, can also be considered grounds for possible termination. Regardless of whether the non-bankrupt partner leaves the relationship, the valuation and operational effects on that firm are not clear. The ability to terminate in this situation could be positive because it provides the opportunity to walk

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away from a weakened partner and put resources toward a higher-valued use without necessarily harming its reputation from modifying the agreement. Alternatively, the partner's bankruptcy could have a detrimental effect if it prematurely ceases the benefits that had been accruing from the agreement or harms the operations and growth of the non-bankrupt partner. Despite the increasing frequency and importance of alliances and joint ventures to corporate investment and growth, there is still little systematic evidence whether the distress of one party produces spillover effects for the other partner.[2] We fill this gap by examining whether the bankruptcy filing of one party in a strategic alliance or joint venture affects the valuation and operating performance of the non-bankrupt partner.

For the 1989–2007 time period, we present evidence that the bankruptcy filing of one party in a collaborative agreement is met with a negative stock price reaction for the counterparty. Furthermore, the non-bankrupt partners exhibit declines in profit margins and investment in the subsequent years after the partner firms file for bankruptcy. This evidence is consistent with the notion that bankruptcies have significant spillover effects on contracting parties. Thus, our work contributes to previous studies that have documented important contagion effects of financial distress and bankruptcy filings on customers, suppliers, and competitors (see Lang and Stulz, 1992; Hertzel, Li, Officer, and Rogers, 2008).

We also investigate whether these negative effects are largely anticipated or unexpected by the market. Often bankruptcies are the culmination of a long slide into distress, and therefore, it is possible that the market has already incorporated the expected effects of the partner's distress into the counterparty's stock price. We find that the negative stock price effects are primarily confined to the bankruptcy filing announcement and that the full effects do not seem to be anticipated in the pre-filing period.

To ascertain whether the spillover effects are stronger for certain types of partnerships, we study a number of key characteristics of the firms and partnerships. First, we analyze whether the bankruptcy effects differ between long-duration and short-duration partnerships. Longer-duration agreements are likely to occur when the parties find the ongoing relationship to be particularly valuable. Hence, the occurrence of a bankruptcy filing would have the most detrimental impact for the counterparty in these situations. Robinson and Stuart (2007) also note that longer projects are more likely to have unanticipated events occur, so the bankruptcy would be less expected at the inception. Furthermore, if the parties anticipate distress, they might structure the partnership differently to mitigate any spillover effects. We find that the negative stock and operating performance is primarily found in the longer-term agreements, indicating that partner firms suffer more when the agreement is likely to have greater value.

Next, we explore whether organizational structure—strategic alliance or joint venture—is an important determinant for the magnitude of the bankruptcy effects. Both types of collaborative arrangements involve significant negotiations to divide the income and intellectual/physical assets stemming from the venture, but while strategic alliances are cooperative arrangements between distinct firms set up to reach a common goal, joint ventures (JVs) create a new legal entity that operates separately from the contributing parties' core operations. Consequently, each type of structure possesses some distinct contractual features that could either exacerbate or mitigate the impact of a counterparty bankruptcy. For example, strategic alliances are more fluid with greater ambiguity regarding specific goals, and consequently might be easier and quicker to unwind, but also more likely to involve the parties' core business practices. In contrast, JVs have clear boundaries that could better insulate the parties' remaining assets, but might involve more costs and rely heavily on the full participation of each party.

We divide the sample by each type of arrangement and find that the negative stock price and operating performance effects are concentrated in the strategic alliance subsample, with little evidence of spillovers for JV partners. In further analysis, we find support for the notion that both the types of projects and firm characteristics at the time of the inception of the relationship affect the choice of strategic alliance versus JV. Consequently, these results suggest that JV agreements are more insulating to the partner firm, but that the partners may factor this consideration into their choice of organization form.

Other aspects of the agreements, such as relationship-specific investments and financial constraints, could affect the gains accruing from the relationship, and hence, the valuation effects and operational impacts from the bankruptcy filing. To explore this issue, we first study how the presence of equity stakes and board participation influence the bankruptcy's impact and find significant negative wealth effects associated with the presence of those. In addition, we divide the data by low research and development (R&D) versus high R&D industries, horizontal versus vertical agreements, and financially constrained versus financially unconstrained firms. In all instances we continue to find that the negative wealth effects are the strongest for long-term alliance partnerships and alliances with high estimated benefits. Despite these declines, there is no significant change in bankruptcy probability for the non-bankrupt long-term, alliance partners.

We also provide evidence that industry performance impacts the returns to the partner firms. In particular, partners in horizontal relationships with firms that go bankrupt, but are from better-performing industries, tend to fare better. Likewise, a declining industry results in worse returns. This finding is consistent with the notion that spillover effects are exacerbated when the company's own prospects are weaker and might not have many alternatives for finding a replacement partner.

The remainder of the paper is organized as follows. In Section 2, we discuss prior literature and findings on strategic alliance and joint venture arrangements. Section 3 describes the data sample process. In Section 4,

[2] Robinson (2008) notes that alliance arrangements have grown by 16% per year since 1985.

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