Journal of Corporate Finance 50 (2018) 128–157

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Does corporate lobbying activity provide useful information to credit markets?☆

George Brandon Lockhart [a], Emre Unlu [b,*]

[a] Department of Finance, Clemson University, Clemson, SC 29634, United States
[b] Department of Finance, University of Nebraska-Lincoln, Lincoln, NE 68516, United States

ARTICLE INFO

Article history:
Received 20 April 2017
Received in revised form 12 December 2017
Accepted 10 March 2018
Available online 21 March 2018

JEL classification:
D78
G18
G31
G38
H23
H25
O38

Keywords:
R&D
asset substitution
lobbying
government subsidy
capital structure

ABSTRACT

Although corporate lobbying can be motivated for numerous reasons, much of corporate lobbying is aimed to secure public subsidies for the firm's high-risk R&D investment, which aggravates the shareholder-creditor conflict. This paper examines how creditors respond to the firm's lobbying that pursues R&D subsidies. Using syndicated bank loan data, we show that R&D-targeted lobbying activity aggravates shareholder-debtholder conflicts and results in debt rationing, shorter debt maturity, and larger loan spreads. We find weak evidence that creditors also impose tighter covenants. We also show that these effects are generally increasing in the firm's R&D intensity. These results are robust to instrumental variable estimations that endogenizes the decision to lobby by instrumenting cost of lobbying with the number of Electoral College representation in the firm's headquarters state. Further analyses show that R&D-targeted lobbying activity is positively related to the value of equity, suggesting that costs of creditor-imposed restrictions do not dominate the benefits of R&D-targeted lobbying. Overall, our findings suggest that the firm's lobbying activity provides useful incremental information to creditors in resolving informational and adverse selection problems in lending transactions.

1. Introduction

Lobbying has long been used to gain political influence in the U.S. According to Congressional history, American Revolution veterans groups were lobbying the Congress as early as 1792, well before initial lobbying regulations were implemented in 1876 (Byrd, 1991). Presently, the scale and growth of lobbying remains substantial. With 12,398 registered lobbyists as of

☆ We are especially grateful to Gary Guenther at the Congressional Research Service for his thoughtful and detailed responses to our many tax credit and R&D policy questions. We also thank Arthur Allen, Lucy Chernykh, Aaron Crabtree, Richard DeFusco, Mark Flannery, Scott Frame, Kathleen Fuller, Jon Garfinkel, John Geppert, Dolly King, Andre Liebenberg, Ivonne Liebenberg, Angela Morgan, Manferd Peterson, David Smith, Tilan Tang, Paul Tanyi, Bonnie Van Ness, Robert Van Ness, Mark Walker, and Jack Wolf, as well as other seminar participants at Clemson University, University of Nebraska-Lincoln, University of North Carolina-Charlotte and University of Mississippi, for their helpful comments and suggestions. We also thank the Center for Responsive Politics for access to lobbying expenditure data. Lockhart thanks the Constance Miriam and Ethel Corrine Syford Memorial Fund (WBS # 26-0608-9001-002) at the University of Nebraska-Lincoln for financial support.

* Corresponding author.
E-mail addresses: blockha@clemson.edu (G.B. Lockhart), emre@unl.edu (E. Unlu).

https://doi.org/10.1016/j.jcorpfin.2018.03.003
0929-1199/

2012, the U.S. has witnessed a dramatic increase in aggregate lobbying expenditures from $1.45 billion in 1998 to $3.30 billion in 2012.[1]

Lobbying is particularly important for corporations. Relative to alternative means of seeking political influence, such as corporate PAC contributions, lobbying is by far the most popular method by which corporations exercise political strategy (Chen et al., 2015). Richter et al. (2009) suggest that one important motivation for corporate lobbying activity is to gain subsidies for R&D investment, which is a much riskier form of investment relative to capital investment.

Agency theory (e.g., Jensen and Meckling, 1976) predicts that shareholders and creditors have different preferences over how much risk the firm should assume, due to the asymmetric payoffs of debt and equity claims. Shareholders have an incentive to pursue high-risk investment, at the expense of creditors, because creditors shoulder the downside returns and do not capture much of the upside returns. In equilibrium, creditors understand these incentives and respond ex ante by modifying the terms of the lending agreement (e.g., credit availability, maturity, price, as well as covenant structure).

The purpose of this paper is to examine whether corporate lobbying, targeted at R&D subsidies, provide useful information to mitigate potential shareholder-creditor conflicts arising from high-risk investment. We hypothesize that a firm's R&D-targeted lobbying serves as a precursor of future high-risk investment. Observing the firm's recent lobbying activities, creditors respond accordingly by adjusting the terms of debt contracting. Thus, our analysis is motivated to test whether creditors respond to a firm's disclosure of R&D-targeted lobbying activity in an effort to protect the value of their claims. After finding supporting evidence that creditors react R&D-targeted corporate lobbying as risk-increasing events, we test whether the net effect of corporate lobbying increases overall firm value.

To preview our findings, we show that when dealing with a lobbying firm that targets R&D subsidies, creditors ration debt, lend with shorter maturity, and require larger loan spreads. We find some weak evidence that loan agreement covenant structure is also tightened in response to the firm's R&D lobbying. Further analysis shows that R&D-targeted lobbying contributes positively to firm value, suggesting that the expected benefits of lobbying exceed the costs. Overall, our evidence suggests that debt financing opportunities are affected when firms allocate resources to acquiring subsidies that encourage additional high-risk investment. Thus, disclosure of such lobbying activity provides useful information to the firm's creditors. After observing the firm's lobbying activity, creditors impose costly financing restrictions to protect the value of their claims. We find that these costs are dominated by the expected benefits of the lobbying, justifying managers' decisions to engage in R&D-targeted lobbying in the first place.

We start our analysis by confirming the positive link between corporate lobbying and high-risk R&D investment that is proposed in Richter et al. (2009). Using a sample of 38,721 firm-year observations covering the 1998–2010 period, we show that past R&D-targeted lobbying activity (measured with a dummy or with a continuous variable) is a strong predictor of future R&D investment.[2] This predictive ability is incremental to the predictive ability of traditional variables used in the past literature. On average, firms that lobby for R&D subsidies have significantly higher R&D investment, amounting to 4.1% of assets, which is economically quite significant. These findings remain robust to endogenizing the lobbying decision with a selection model. Overall, these findings are consistent with the interpretation that R&D-targeting lobbying is a credible signal of increases in future R&D investment, through which shareholder-creditor conflicts can be exacerbated.

Next, we examine features of debt contracts that might be affected by lobbying activity that is targeting R&D subsidies. Specifically, we consider debt maturity, debt rationing, cost of debt and covenant restrictions.

Lenders can respond to investment risk by decreasing the amount they are willing to lend (Harris and Raviv, 1990; Myers, 1977; Williamson, 1988), and/or by decreasing the maturity of the debt that they choose to lend (Diamond, 1991; Sharpe, 1991). We use Johnson's (2003) simultaneous equation setting, and a sample of 26,959 firm-year observations from 1998 to 2010, to estimate the impact of R&D-targeted lobbying on the level and maturity of debt. We find that R&D-targeted lobbying firms have lower leverage ratios (4.2% of assets on average), and have greater portion of their debt with shorter maturity (2.7% of total debt on average). In addition, we find that the debt rationing effect is amplified in the firm's R&D intensity by a factor of 1.28. These findings suggest that R&D-targeted lobbying activity concerns lenders even more when the existing R&D investment is high.

Next, we use a sample of 12,250 loan-year observations on private loans extended during the 1999–2008 period to examine the effect of corporate lobbying on the cost of bank debt and covenant structure. We show that creditors charge larger loan spreads (an average 15.73 basis points) for firms with R&D-targeted lobbying activity. Furthermore, interaction-effects regressions suggest that, depending on the firm's R&D intensity, additional loan spread due to R&D-targeted lobbying can range between 8.81 and 33.78 basis points. These results confirm our prior analysis that creditors view lobbying activity as a precursor of future high-risk investment, and respond by requiring greater loan spreads. Unlike Eberhart et al. (2008), who analyze the effects of R&D on public bond values, we focus on private loans because private lenders have the greatest incentive to produce price-pertinent information (in our case, the creditors' view on lobbying), due to the relatively concentrated ownership of the debt, and to the relatively less-costly renegotiation characteristics of private debt (Smith and Warner, 1979; Diamond, 1991; Gertner and Scharfstein, 1991 and Julio, 2007). We confirm the main finding of Eberhart et al. (2008) that, on average, R&D investment decreases credit spreads. However, this result reverses for firms that engage in R&D-targeted lobbying.

We also analyze private loan covenants and find some *weak* evidence that creditors impose tighter covenants when lending to an R&D-related lobbying firm. Specifically, out of 36 estimations, seven suggest a statistically significant relation implying that creditors impose tighter covenants in response to R&D-targeted lobbying. Another 28 estimations yield statistically insignificant

[1] These statistics are from the Center for Responsive Politics (www.opensecrets.org).

[2] Our sample period starts in 1998 because comprehensive data coverage for lobbying disclosure begins in January 1998.