Firing Costs and Capital Structure Decisions

FIRING COSTS AND CAPITAL STRUCTURE DECISIONS

by

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ABSTRACT

I exploit the passage of wrongful discharge laws by U.S. state courts that allow workers to sue employers for unjust dismissal as an exogenous increase in employee firing costs. I find that firms reduce debt ratios following the adoption of these laws, and this result is strongest for subsamples of firms that experience larger increases in expected firing costs. Following the passage of these laws, firms also increase cash holdings, firms save more cash out of cash flows, and investors place a higher value on each additional dollar of cash holdings. Overall, my results indicate that employee firing costs can have an important impact on corporate financial policy decisions.

1. Introduction

When firms dismiss workers, they can incur substantial firing costs, which are any costs associated with discharging or firing employees. These costs include, but are not limited to, legal fees and settlements associated with lawsuits arising from violations of labor protection laws.[1] Under the traditional employment "at-will" rule in the United States, these firing costs are relatively low because employers are free to terminate any employee without warning and for any reason without the risk of legal liability. However, in an attempt to protect employees from unfair dismissal practices, legislation passed over the last half-century has created a legal precedent that allows employees to sue employers for wrongful termination. These laws have resulted in a significant increase in layoff-related lawsuits and firing costs. For instance, wrongful dismissal lawsuits have risen 260% over a recent 20 year period (Boxold (2008)),[2] and 46% of surveyed public firms express concerns regarding financial losses arising from such lawsuits.[3]

In this study, I investigate how an exogenous increase in employee firing costs impacts firms' financial policies, focusing on the relation between firing costs and capital structure decisions. I hypothesize that firing costs can affect financial leverage choices through two related channels. First, given that financially distressed firms are often forced to lay off workers to cover cash flow shortfalls (e.g., Ofek (1993); Kang and Shivdasani (1997)), firing costs are a part of a firm's total costs of financial distress. In terms of the traditional trade-off theory of capital structure (e.g., Kraus and Litzenberger (1973); Scott (1976); Bradley, Jarrell, and Kim (1984); Graham (2003)), an increase in firing costs raises financial distress costs and offsets the tax

[1] Firing costs can also arise through several other channels including but not limited to: (1) severance payments, (2) delays or disruptions in production due to bureaucratic discharge procedures and time spent fighting lawsuits, (3) other special costs associated with social compensation plans, such as mandatory retraining or outplacement services, and (4) loss of reputation as an employer of choice for recruiting and retaining desirable employees. Broadly, firing costs are a subset of labor adjustment costs, which include the costs associated with firing, hiring, and training employees. These costs can be substantial, amounting to as much as one year of payroll costs for the average worker (Hamermesh and Pfann (1996); Abowd and Kramarz (2003)).

[2] A more recent survey also finds that the number of federal wrongful termination lawsuits has increased substantially in recent years. Between 2005 and 2010, the frequency of these lawsuits has increased from 39,102 to 55,019, a 40.7% increase. See Laila Haider and Stephanie Plancich, "Damage Estimation in Wrongful Termination Cases: Impact of the Great Recession," *NERA Economic Consulting*, March 29, 2012.

[3] See Chubb Group of Insurance Companies, "U.S. Public Companies' Perceptions of Risk, and Their Risk Mitigation Strategies," *Chubb 2012 Public Company Risk Survey*, 2012.

benefits of debt financing. Thus, higher firing costs directly lower optimal financial leverage ratios. Second, higher firing costs make it more difficult for a firm to lay off workers when it needs to do so, such as during economic downturns (e.g., Bentolila and Bertola (1990); Autor, Donohue, and Schwab (2006); Messina and Vallanti (2007)), indirectly making labor costs more fixed in nature. This greater rigidity of labor costs can raise a firm's operating leverage, and as a result, lower the firm's optimal debt ratio (e.g., Mandelker and Rhee (1984); Mauer and Triantis (1994); Kahl, Lunn, and Nilsson (2013)).

To test my hypothesis, I adopt a difference-in-differences research design. Specifically, I exploit the quasi-natural experiment created by the passage of Wrongful Discharge Laws (WDLs) by U.S. state courts over the 1967 to 1995 period as an exogenous increase in employee firing costs. WDLs are exceptions to the long-standing doctrine that an employer can terminate its employees at-will. These laws allow employees to sue employers for unjust dismissal, and employees can sue for lost earnings, pain and suffering, and punitive damages.

Importantly, WDLs increase the costs associated with dismissing employees and therefore provide an appealing setting for testing how increases in firing costs impact capital structure decisions. Based on wrongful termination cases that reached the trial stage in 1996, Jung (1997) estimates that plaintiffs prevailed in 46.5% of cases and won $1.29 million on average. Given that an individual firm can at the same point in time be subject to numerous wrongful termination lawsuits, the costs resulting from these lawsuits can become very significant. Supporting this notion, Bird and Knopf (2009) show that these laws reduce firm profitability and increase labor expenses. Further, Autor (2003) finds that following the passage of WDLs, firms increase their use of temporary workers, who can easily be dismissed, while Dertouzos and Karoly (1992) and Autor, Donohue, and Schwab (2006) document that overall employment levels decrease within a state.

To implement the difference-in-differences analysis, I use panel regression techniques that control for firm and year fixed effects, firm characteristics known to impact capital structure decisions, and state GDP growth rates. The inclusion of firm and year fixed effects controls for time-invariant firm-level unobserved factors and for macroeconomic trends, while state GDP

growth rates help ensure that local economic conditions do not spuriously drive my results. Consistent with an increase in firing costs lowering optimal debt ratios, I find that, on average, market and book leverage ratios decrease by 4.5% and 6.0%, respectively, relative to their sample means following the passage of one particular WDL—the good faith exception.[4] This exception in its broadest sense protects employees from termination for any reason other than for a "just cause."

The enactment of WDLs is based on judicial rather than legislative decisions, implying that judges' decisions are more likely driven by the merits of the case than political economy considerations (Autor (2003); Acharya, Baghai, and Subramanian (2014)). To further alleviate endogeneity concerns, however, I next investigate the extent to which controlling for variables related to local economic conditions or changes that a firm makes to the composition of its workforce or operations in response to the passage of WDLs affects my findings. The results show that the negative relation between the adoption of the good faith exception and financial leverage ratios is robust to controlling for state unemployment rates, state unionization rates, the passage of other labor laws, the strength of labor laws in bordering states, and the tendency of a firm to employ more temporary workers and use less labor-intensive assets following the passage of WDLs. I also find that changes in leverage appear only after and not before the passage of the good faith exception, implying that the relation between the adoption of this law and financial leverage changes is not attributable to reverse causality.

To better understand the economic mechanisms behind my results, I next conduct several cross-sectional tests to exploit settings where the effect of the passage of WDLs on financial leverage ratios is expected to be larger. Firms that employ a larger fraction of workers that are likely protected by WDLs or that are more likely to file wrongful termination lawsuits should face larger increases in expected firing costs subsequent to the passage of WDLs. Thus, the

[4] WDLs ultimately matured into three common law exceptions: the good faith exception, the implied contract exception, and the public policy exception. While some states recognize all three exceptions, others recognize two, one, or none at all. My finding that the passage of the good faith exception has the greatest impact on a firm's capital structure decisions is consistent with previous studies that argue that the good faith exception is potentially the most far-reaching of the three (e.g., Dertouzos and Karoly (1992); Kugler and Saint-Paul (2004)). I discuss these three exceptions in more detail in Section 2.1.

negative relation between the adoption of the good faith exception and changes in debt ratios is expected to be especially strong for these types of firms. In particular, WDLs are less applicable to temporary workers and do not generally pertain to workers already covered by collective bargaining agreements (Miles (2000); Autor (2003)). Also, workers are more likely to file wrongful termination lawsuits when they have greater annual income and during difficult economic times when the unemployment rate is higher (Dertouzos, Holland, and Ebener (1988); Autor, Donohue, and Schwab (2006)). Consistent with an increase in firing costs causing a decrease in debt ratios, I find that the negative relation between the passage of the good faith exception and financial leverage is strongest in subsamples of firms that: (1) have more full-time workers, (2) employ fewer workers that are represented by labor unions, (3) compensate their workers with greater annual wages, or (4) are located in states with higher unemployment rates.

Further, firms that, in general, have a higher propensity to lay off workers face larger increases in expected firing costs subsequent to the adoption of WDLs and should therefore reduce their financial leverage ratios more following the passage of these laws. To identify such firms, I measure firms' industry layoff rates and likelihood of becoming financially distressed. A firm that operates in an industry in which firms in general have a higher propensity to lay off workers should be more likely to discharge its own employees. Also, a firm that faces a higher likelihood of defaulting on its debt could be more likely to need to lay off some of its workers in order to meet its outstanding debt obligations (e.g., John, Lang, and Netter (1992); Ofek (1993)). Consistent with this prediction, I find that the negative relation between the passage of the good faith exception and leverage is strongest in subsamples of firms that operate in industries with higher layoff propensity rates or that have a higher likelihood of defaulting, as measured by a lower modified Altman's z-score.

In my final set of analyses, I examine how the passage of the good faith exception affects a firm's cash management policies. In addition to using less debt financing, a firm can hold more cash to reduce the likelihood of resorting to costly layoffs to cover cash flow shortfalls. This effect implies that a firm's optimal amount of cash holdings could also increase following the passage of WDLs. Consistent with this prediction, I find that firms increase cash holdings by

approximately 9.4% following the adoption of the good faith exception.

Likewise, if following the passage of the good faith exception it is optimal for a firm to hold more cash to avoid the threat of costly layoffs, then after the law is adopted, the contribution of cash holdings to firm value should increase and the firm should save more cash from its cash flows. To test these predictions, I first follow the methodology in Faulkender and Wang (2006) and estimate changes in the marginal value of firms' cash holdings. I find that investors place a higher value on each additional dollar of cash holdings following the enactment of this law ($0.76 vs. $0.59). To test the second prediction, I adopt the methodology in Almeida, Campello, and Weisbach (2004) and examine changes in firms' cash flow sensitivity of cash. I find that before the passage of the good faith exception, firms save $0.36 per dollar of cash flow. Following the adoption of this law, however, this savings rate increases to $0.45 per dollar of cash flow. Together, these cash holdings-related findings imply that firms optimally raise their cash holdings when expected firing costs increase and that one way they do this is by saving more cash out of their cash flows.

The central contribution of this paper is that I provide novel empirical evidence that labor market frictions in the form of employee firing costs have a significant impact on firm financial policies. While my study broadly contributes to the literature examining the determinants of capital structure decisions (e.g., Titman and Wessels (1988); Rajan and Zingales (1995); Lemmon, Roberts, and Zender (2008)), it is closely related to the growing body of research that considers how labor market frictions can impact financial policies (e.g., Berk, Stanton, and Zechner (2010); Matsa (2010); Shivdasani and Stefanescu (2010); Benmelech, Bergman, and Enriquez (2012); Agrawal and Matsa (2013); Kim (2013), among others). These latter studies show that financial leverage decisions can depend on employee unemployment risk, pension plan funding, strategic bargaining with organized labor, and the size of local labor markets. In contrast, my paper provides unique insights into how firing costs that are conditional on worker layoffs impact *ex ante* financial policies.[5]

[5] My paper also relates to three contemporaneous papers that examine how labor adjustment costs that arise in different empirical settings affect financing decisions. First, Simintzi, Vig, and Volpin (2014) find a negative

To the best of my knowledge, my study is the first to investigate how U.S. labor protection laws impact financing decisions. Within the U.S., firms headquartered in different states share the same national political economy, have similar constraints in accessing capital markets, and share many cultural norms. Thus, focusing my analyses on U.S. firms and U.S. state-level laws helps to mitigate concerns that omitted variables could lead to a spurious association between capital structure and the adoption of employee protection laws. Further, I study how the passage of individual laws that protect non-unionized workers from unjust dismissal impact firms' financing decisions. In doing so, I contribute to work documenting that the effect of labor market frictions is not limited to situations involving organized labor (e.g., Agrawal and Matsa (2013); Kim (2013)).

My study also increases our understanding of the determinants of corporate cash holdings (e.g., Opler, Pinkowitz, Stulz, and Williamson (1999); Bates, Kahle, and Stulz (2009)), and specifically to work relating labor markets to cash holdings (e.g., Klasa, Maxwell, and Ortiz-Molina (2009)). This latter study shows that firms strategically lower their cash holdings to gain bargaining advantages over labor unions, while my results suggest that firms increase their cash holdings to reduce the likelihood of costly layoffs.

Lastly, my study contributes by providing insights on how the risk of litigation affects a firm's financing decisions. The existing evidence on this issue is mixed. Notably, Arena and Julio (2012) document that a firm that faces a greater risk of securities litigation holds more cash to cover anticipated litigation expenses. However, Crane (2011) reports that, to limit potential payouts to litigants, a firm raises its leverage ratio and decreases its cash holdings following increases in its exposure to litigation risk. In contrast, my finding that leverage decreases and cash holdings increase following the passage of WDLs is consistent with firms *ex ante* reducing

relation between financial leverage and an index of country-level employment protection legislation that captures the procedures involved in hiring workers on fixed-term or temporary work contracts, the procedures and costs involved in dismissing workers, and regulations applying to collective dismissals. Second, Schmalz (2013) uses a regression discontinuity design to study a set of firms that elect whether to have union representation and shows that firms increase cash holdings and decrease debt ratios following unionization, which proxies for an increase in labor adjustment costs. Lastly, Kuzmina (2013) examines how the use of full-time rather than temporary workers impacts leverage decisions. Using Spain's government subsidies of full-time labor contracts as an instrumental variable for the use of full-time employees, Kuzmina (2013) finds that the greater operating leverage associated with employing more full-time workers results in lower debt ratios.

financial risk to mitigate litigation risk.

The remainder of the paper is organized as follows. Section 2 discusses the institutional background on WDLs and how I identify the passage of WDLs by state courts. Section 3 develops the study's principle hypothesis. Section 4 describes the data and empirical methodology. Section 5 reports the main empirical results. Section 6 discusses additional robustness tests. Section 7 concludes.

2. Wrongful Discharge Laws

2.1. Institutional Background

Under the traditional rule in the U.S., employers are free to terminate any employee without the risk of legal liability. Thus, for good reason, bad reason, or no reason at all and with or without prior notice, employers could terminate employees "at-will." However, beginning in the 1970s, many states began recognizing exceptions to the terminate at-will rule. These common law exceptions are typically known as WDLs. Unlike federal laws aimed at protecting a particular class of workers, such as union members, racial minorities, women, and the aged, these exceptions pertain to workers not already covered by federal legislation or by explicit contractual agreements (Miles (2000)).

There are three widely recognized exceptions to the terminate at-will rule, and states can choose to adopt none, any, or all three of these exceptions.[6] First, the good faith exception protects employees from termination for "bad cause" and serves to prevent employers from denying employees their contract rights. For example, if an employer fires a salesperson just before a commission is due or fires an employee just before her pension vests, the employee can sue the employer under the good faith exception.

The second exception is the implied contract exception, which protects employees from termination when the employer has implicitly promised employees that they will not be discharged without good cause. These promises may be oral, or if written in a handbook, they do not need to be negotiated with employees individually. Courts have also determined that

[6] See Dertouzos and Karoly (1992), Miles (2000), and Autor, Donohue, and Schwab (2006) for a more in-depth discussion of the legal definition and significance of WDLs.

employee tenure, a history of promotions or salary raises, general company policies, and typical industry practices can constitute an implied promise to employees of ongoing employment.

Lastly, the public policy exception protects employees from termination for refusing to violate an established public policy or illegal act, such as reporting an employer's wrongdoing, refusing to commit perjury, filing a worker's compensation claim, or performing jury duty. The underlying motivation behind the public policy exception is that employees should not be discharged for performing a public service even if the action is not in the employer's interest.

As already discussed, the results from academic studies and anecdotal evidence suggest that WDLs are costly. It is difficult to estimate how many wrongful discharge cases are filed annually because the decisions in many cases are never published and are often settled before trial. An early study, however, estimates that at any point in time there are about 20,000 such cases pending in state courts (Westin and Feliu (1988)). This number of cases is likely higher in later years, as more states pass WDLs. Further, firms not only incur direct costs but also indirect costs when they use resources to revise employment handbooks, implement bureaucratic discharge procedures, hire legal counsel, increase documentation requirements, or simply retain unproductive workers to minimize the direct costs of lawsuits (Lazear (1990); Autor (2003)).

2.2. The Passage of Wrongful Discharge Laws by State Courts

The identification of the precedent setting court cases that signal that a state has passed a particular WDL is central to my analyses. I base my coding of the passage of WDLs on the precedent setting cases provided in Autor, Donohue, and Schwab (2006).[7] They search for the first major appellate-court decision that signals the sustained adoption of a particular employment at-will exception. If a lower court decision adopting the exception is reversed on appeal, then this state is not coded as passing the exception. However, a state Supreme Court decision or a lower court decision that is not later reversed is coded as the passage of a particular employment at-will exception. This coding is done for the good faith, implied contract, and

[7] Due to the subjectivity in identifying precedent setting cases, in Section 6.1, I examine the robustness of my main findings to using the coding provided by different authors. Specifically, the alternative coding schemes that I analyze include the exact coding by Autor, Donohue, and Schwab (2006), Dertouzos and Karoly (1992), and Morriss (1995). I find similar results across the various coding schemes.

public policy exceptions individually. In contrast to Autor, Donohue, and Schwab (2006), I also code Utah as recognizing the good faith exception since 1989, as is done in Walsh and Schwarz (1996) and Littler (2009). Following recent studies that examine the effect of labor laws on corporate decisions (e.g., Agrawal and Matsa (2013); Acharya, Baghai, and Subramanian (2014)), I match these laws to the state where each firm is headquartered.[8]

Table I summarizes the dates when individual states passed each particular exception, and Figure 1 shows the number of states that have passed each exception in each year between 1959 and 1998. As seen in the table and figure, there is substantial variation in the passage of all three exceptions across states and over time. The majority of states passed WDLs beginning in the early 1970s through the early 1990s. For example, one, two, and five states had passed the good faith, implied contract, and public policy exceptions in 1975, respectively. By 1995, 12 states had passed the good faith exception, while 41 and 43 states had passed the implied contract and public policy exceptions, respectively.

3. Firing Costs and Capital Structure

3.1. Hypothesis Development

In this section, I discuss how an increase in firing costs could affect a firm's optimal amount of debt financing. I propose that higher firing costs affect financial leverage decisions through two inherently related channels: (1) higher firing costs directly lower the tax benefits of debt financing by increasing the costs of financial distress, and (2) higher firing costs indirectly make labor expenses more rigid, thereby increasing operating leverage and reducing debt capacity.

First, in the traditional trade-off theory of capital structure, firms trade off the benefits from tax shields against financial distress costs (e.g., Kraus and Litzenberger (1973); Scott

[8] Because employment laws typically apply to the state where the employee is working, firms are assigned to a state on the basis of their headquarters location. If firms have plants located in states different than their headquarters, then those plants would typically be subject to different employment laws. In addition, Compustat provides only the latest headquarters locations. If firms relocate their headquarters to a different state, then these firms would be subject to different employment laws in the earlier periods. Such measurement error may attenuate my results. In Section 6.3, I conduct additional robustness tests to investigate the extent to which such measurement error affects my findings and find evidence suggesting that it does not have an important effect on my results.

(1976); Bradley, Jarrell, and Kim (1984); Graham (2003)). Further, several studies suggest that firms are often forced to lay off workers to reduce costs in order to meet outstanding debt obligations after becoming financially distressed (e.g., John, Lang, and Netter (1992); Ofek (1993); Kang and Shivdasani (1997); Denis and Kruse (2000)). In my empirical setting, firms that fire workers can incur substantial firing costs due to legal fees and settlements associated with lawsuits arising from wrongfully terminating employees. As such, higher firing costs increase the total costs of financial distress. Consequently, if firing costs increase, this effect directly reduces the tax benefits of debt and should result in lower optimal financial leverage ratios. In the empirical analysis that follows, I exploit the passage of WDLs that increase financial losses associated with worker layoffs. Thus, this positive shock to firing costs could reduce the benefits of debt financing and result in lower optimal financial leverage ratios.

Second, while an increase in firing costs can directly lower a firm's optimal amount of debt financing, there is also an indirect effect. Specifically, higher firing costs can magnify operating leverage by making labor costs more rigid. When it is costlier to dismiss employees, firms are less likely to lay off workers during economic downturns. This result has been documented in international settings. For example, Messina and Vallanti (2007) show that more stringent European firing laws significantly weaken the response of layoffs to the business cycle. Similarly, using a set of Italian firms, Kugler and Pica (2008) find that higher dismissal costs reduce worker separation rates.[9] This lower sensitivity of employee layoffs to economic downturns makes labor costs more fixed in nature, resulting in greater operating leverage. Higher operating leverage ultimately results in lower debt capacity due to more volatile cash flows and consequently lowers optimal financial leverage ratios (e.g., Van Horne (1974); Mandelker and Rhee (1984); Mauer and Triantis (1994); Kahl, Lunn, and Nilsson (2013)).

In sum, if an increase in expected firing costs raises the costs of financial distress and/or increases operating leverage, both effects should result in lower optimal financial leverage ratios.

[9] While there is strong international evidence that firms are less likely to lay off workers when employment protection laws increase firing costs, this evidence is weaker for U.S. firms. For instance, Autor, Donohue, and Schwab (2006) find weak evidence that WDLs lower separation rates. In Section 5.4, I reexamine whether the passage of WDLs lowers separation rates for my sample of firms and find that firms are less likely to lay off workers following negative cash flow shocks if they are headquartered in a state that has adopted the good faith exception.

Thus, the above arguments lead to the study's principal hypothesis:

> *Hypothesis: An increase in a firm's employee firing costs arising from the passage of wrongful discharge laws leads the firm to reduce its financial leverage ratio.*

3.2. Further Discussion of Hypothesis

My hypothesis assumes that firms face financial losses if they are sued by employees. In practice, however, firms can purchase Employment Practices Liability Insurance (EPLI) that protects them against such lawsuits, but evidence is mixed on how many firms buy EPLI. For example, the 2012 Chubb Group of Insurance Companies survey reports that 68% of firms purchased EPLI, while another survey finds that 50% of respondents had EPLI in 2012.[10] Further, a 1997 survey finds that only 22% of employers purchased EPLI.[11] In sum, while EPLI may serve to lower expected firing costs, not all firms purchase this insurance. In addition, there are limits to the amount of losses insurance covers, and the premiums paid to purchase this insurance still represent an indirect cost of employment protection laws. Nevertheless, to the extent that insurance reduces expected firing costs, the presence of EPLI should lead to a bias against finding a negative relation between the passage of WDLs and financial leverage ratios.

It is also important to acknowledge that there are two strands of literature that could potentially generate the prediction that debt ratios would rise following increases in firing costs resulting from the adoption of WDLs. First, the inability of an employer to terminate a worker at-will could shift bargaining power to the employee and lead to increased wage demands on the part of the employee. In response, firms can improve their bargaining position by increasing financial leverage to tie up cash flows that could otherwise be used to raise wages (Bronars and Deere (1991); Matsa (2010)). Thus, if the passage of WDLs increases employee bargaining power, firms might raise debt ratios. This effect, however, applies mostly in the context of labor unions, which have the ability to capture firm profits when they have greater bargaining power. Because WDLs generally pertain to workers not covered by collective bargaining agreements (Miles (2000)), it seems unlikely that this bargaining power argument applies in my empirical

[10] See "2012 Insurance Coverage Survey Results," *Zywave, Inc.*, 2012.
[11] See "1997 Employment Litigation Survey," *Society for Human Resource Management*, 1997.

setting.

Second, prior work suggests that firms trade off the benefits of debt financing against higher wages demanded by workers in compensation for bearing a higher risk of costly unemployment if the firm were to go bankrupt or experience severe financial distress (e.g., Titman (1984); Berk, Stanton, and Zechner (2010); Agrawal and Matsa (2013)). In particular, because financial leverage increases the likelihood of unemployment, employees could demand a wage premium in compensation for this higher unemployment risk. These wage premiums would effectively lower the benefits of debt financing, resulting in a negative relation between debt ratios and worker unemployment risk. Thus, if WDLs protect workers from dismissal, these laws could decrease unemployment risk, which could then theoretically lead to lower wage premiums and higher debt ratios. However, this prediction has not held empirically. Specifically, prior work either finds that the passage of WDLs has a positive or no effect on wages (Autor, Donohue, and Schwab (2006); Bird and Knopf (2009)). Thus, in my empirical setting, this wage effect resulting from lower unemployment risk unlikely plays a first-order role in firms' capital structure decisions.

4. Data and Empirical Methodology

4.1. Sample Selection

The main sample that I examine in this paper includes 81,161 firm-years for industrial firms (utilities and financial firms are excluded) that have publicly traded stock over the 1967 to 1995 period, are incorporated in the U.S., and have non-missing data for the main variables of interest. I combine state GDP growth rates from the U.S. Bureau of Economic Analysis with financial statement data from the Compustat annual files.

The sample period starts five years before the second earliest enactment of a WDL when California passed the implied contract exception in 1972. Data limitations prevent the sample from encompassing the first event when California passed the public policy exception in 1959. The sample period ends five years after Ohio passed the public policy exception in 1990. I select to use this year as my cutoff point rather than extending the analysis to cover the last event when

Louisiana passed the good faith exception in 1998 because there are very few additional observations that enter the treatment group (i.e., firms located in states that pass WDLs) when Delaware, Louisiana, Mississippi, and Wyoming pass a WDL. Specifically, there are only about 1.19% of firms headquartered in these states during these later years. Using the extended sample period may create noise around the identification of the effect that the adoption of these laws have on capital structure decisions. Nevertheless, Section 6.2 reports the results of robustness tests that use alternative sample periods.

4.2. General Empirical Methodology

I adopt a difference-in-differences research design to examine the relation between the passage of WDLs and financial leverage at the firm-year level. Specifically, I estimate the following panel regression:

$$Debt_{ist} = \alpha_1 GF_{st} + \alpha_2 IC_{st} + \alpha_3 PP_{st} + X_{ist}\beta + v_i + \omega_t + \varepsilon_{ist}, \quad (1)$$

where $Debt_{ist}$ is a specific measure of financial leverage at firm i in state s and year t, and GF_{st}, IC_{st}, and PP_{st} are indicator variables for whether the state where a firm is headquartered has adopted the good faith, implied contract, and public policy exceptions as of year t, respectively. The regression model also includes a set of control variables X_{ist}, firm fixed effects v_i, and year fixed effects ω_t. The firm fixed effects control for time-invariant omitted firm characteristics and ensure that estimates for α_1, α_2, and α_3 reflect average, within-firm changes in financial leverage over time rather than simple cross-sectional correlations. The year fixed effects account for transitory nation-wide factors, such as macroeconomic conditions, that could affect financial leverage ratios and the likelihood that a state adopts one of the WDLs.

The control variables include the variables commonly found in leverage regressions (e.g., Harris and Raviv (1991); Rajan and Zingales (1995); Frank and Goyal (2008); Lemmon, Roberts, and Zender (2008)). These variables include log assets (a control for firm size), the market-to-book ratio (a proxy for growth opportunities), profitability (a proxy for the availability of internal funds), the proportion of assets that are fixed (a proxy for potential collateral), cash

flow volatility (a proxy for distress risk), and an indicator variable for whether the firm paid a common dividend (a proxy for financial constraints). Following recent work examining the effect of labor market frictions on financial leverage (e.g., Matsa (2010); Agrawal and Matsa (2013)), I also include the modified Altman's z-score to control for a firm's probability of going bankrupt (MacKie-Mason (1990)). Lastly, I include the one-year state GDP growth rate to control for contemporaneous local macroeconomic conditions. Table II presents detailed definitions and summary statistics for these variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. For my main sample, the average ratio of debt to the book value of assets is 25%.

To illustrate my identification strategy, it is helpful to consider an example. Suppose I want to estimate the effect of the passage of the good faith exception in California in 1980 on financial leverage. I can subtract the level of leverage before the law was passed from the level of leverage after the law was adopted for firms headquartered in California. However, economy wide shocks may occur at the same time and affect leverage in 1980. To control for such factors, I calculate the same difference in a control state (say New York) that does not pass the good faith exception in 1980. Finally, I calculate the difference of these two differences, which represents the incremental effect of the enactment of the good faith exception on firms headquartered in the treatment state of California compared to firms headquartered in the control state of New York. The same reasoning applies if I want to identify the effect of the implied contract and public policy exceptions.

The tests run in this study are even more stringent than the simple intuition provided above since they control not only for state-wide differences but also for other firm-specific unobservable and observable differences. Another advantage of my identification strategy is the staggered adoption of WDLs over time, which allows a firm headquartered in a given state to be in both the treatment (if the state passes a particular exception in year *t*) and control group (if the state does not pass an exception in year *t*). As such, the control group is not restricted to firms headquartered in states that never pass WDLs.

I correct estimated standard errors in all regressions for heteroskedasticity and clustering at the state level. Given that the variation in WDLs is at the state level, this clustering method accounts for potential time-varying correlations in unobserved factors that affect different firms within the same state (Bertrand, Duflo, and Mullainathan (2004)). This methodology also corrects for within-firm error term correlations over time and is therefore more general than firm-level clustering.[12]

5. Empirical Results

5.1. Wrongful Discharge Laws and Financial Leverage

I first investigate whether increases in firing costs that arise from the passage of WDLs impact a firm's capital structure decisions. If the adoption of these laws increases financial distress costs and/or raises operating leverage, then the firm's financial leverage should decline following the enactment of WDLs.

To test this prediction, I use two measures of financial leverage. First, *Book Leverage* is total debt divided by book value of assets. I use *Book Leverage* as my primary measure of financial leverage because many managers focus on book leverage rather than market leverage when making capital structure decisions (Graham and Harvey (2002)). Further, Welch (2004) shows that a substantial portion of the variation in market leverage ratios stems from variation in firms' market values rather than changes in debt policies. Nevertheless, in all of my analyses, I also report the results using *Market Leverage* (the book value of long-term debt plus debt in current liabilities divided by market value of assets) because market leverage is more closely tied to theoretical predictions related to target leverage levels. All the results are robust to using book or market leverage as the dependent variable.

Panel A of Table III reports the difference-in-difference estimates relating the passage of WDLs to book leverage ratios. Columns 1-3 examine the effect of the adoption of the good faith, implied contract, and public policy exceptions on book leverage individually without controlling for the passage of the other two exceptions. Column 4 includes indicator variables for the

[12] Because I cluster standard errors at the state level, the critical t-values (two-tailed with 49 degrees of freedom) for significance at the 10%, 5%, and 1% levels are 1.68, 2.01, and 2.68, respectively.

passage of all three exceptions in the same regression. The results in columns 1-4 show a negative and statistically significant relation between book leverage and the adoption of only the good faith exception. In terms of economic significance, the coefficient estimates in column 4 imply that book leverage ratios decline by 1.5 cents of debt per dollar of book assets following the enactment of the good faith exception. Given that the sample mean of book leverage is 25.0%, this finding represents a reduction in book leverage of 6.0% (=0.015 / 0.250) relative to its sample mean.

The finding that firms lower debt ratios following the adoption of only the good faith exception is consistent with arguments and findings in previous studies. First, this exception can imply that termination must always be for cause. Thus, it is likely the most far-reaching of the three and should therefore have the greatest impact on corporate policies (e.g., Dertouzos and Karoly (1992); Kugler and Saint-Paul (2004)). Second, firms can largely prevent lawsuits arising from the implied contract exception by including disclaimers in their personnel manuals and employees' handbooks that state that employment contracts are always at-will (Miles (2000); Autor, Kerr, and Kugler (2007)). Lastly, Autor, Kerr, and Kugler (2007) argue that the public policy exception generally does not impose substantial constraints on employer behavior because courts typically limit cases to clear violations of explicit legislative commands rather than violations of a vaguer sense of public obligation. In sum, because the good faith exception is likely the most far-reaching of the three exceptions and given that I only find that this law impacts leverage ratios, I focus my remaining analyses and discussions on this exception and treat the adoption of the implied contract and public policy exceptions as additional control variables.

The coefficient estimates on the other control variables used in the regression models in Panel A of Table III are consistent with previous findings in the literature. Larger firms use more leverage, and firms with more growth opportunities use less leverage. Firms with more fixed assets and hence more collateral have higher leverage ratios. Finally, firms that pay dividends, are more profitable, and have a lower probability of default have lower leverage ratios.

Panel B of Table III presents the results examining the relation between the passage of

WDLs and market leverage. Consistent with the findings using book leverage as the dependent variable, the results in Panel B show that firms reduce market leverage following the adoption of only the good faith exception. Given that the sample mean of market leverage is 28.6%, the coefficient estimates in column 4 of Panel B imply a reduction in market leverage of 4.5% (=0.013 / 0.286). Overall, the results in Table III support the hypothesis that firms lower their financial leverage ratios in response to an increase in expected employee firing costs.

5.2. Endogeneity of Wrongful Discharge Laws

Two pieces of evidence suggest that the passage of WDLs is exogenous with respect to firms' capital structure decisions. First, the enactment of WDLs is based on judicial rather than legislative decisions, which are more likely driven by the merits of the case than political economy considerations (Autor, 2003; Acharya, Baghai, and Subramanian, 2014). This point implies that lobbying activities unlikely influence the enactment of these laws. Second, Walsh and Schwarz (1996) analyze published court decisions and find that cited reasons for judges adopting WDLs include: (1) enhancing fairness in employment relationships, (2) assuring consistency with established principles of contract law, and (3) following other states that have already passed WDLs. These reasons appear unrelated to factors that could lead firms to reduce their leverage and therefore suggest that the adoption of WDLs likely represents an exogenous shock with respect to firms' financing decisions. Nevertheless, I next conduct two analyses to further help alleviate residual endogeneity concerns.

5.2.1. The Effect of Potential Omitted Variables

While judges' rationales for adopting WDLs appear unrelated to factors that could affect firms' capital structure decisions, it is possible that judges are directly or indirectly motivated by economic factors that they do not cite. Also, firms may react to the passage of WDLs by changing other corporate policies, such as employing more temporary workers or using less labor-intensive assets, which could cause the observed decline in leverage ratios. In these scenarios, the relation between WDLs and financial leverage may be spurious. I explore the empirical relevance of the effect of potential omitted variables by further controlling for several

state-level variables that have been hypothesized to impact a court's decision to adopt WDLs. I also include variables to control for a firm changing the composition of its labor force and labor-to-capital mix as a result of the passage of these laws. Table IV presents the results of this analysis. The dependent variable in Panel A is book leverage, and the dependent variable in Panel B is market leverage.

First, Dertouzos and Karoly (1992) suggest that legislators may be more likely to pass WDLs when the unemployment rate in the state is higher because there is a larger fraction of workers that could have benefited from employment protection. Thus, column 1 includes the state-level unemployment rate as an additional control variable. I define the unemployment rate as the fraction of workers within a state that are in the labor force but are unemployed. The unemployment rate is based on data from the Current Population Survey (CPS) each year. Specifically, data are from the Integrated Public Use Microdata Series (IPUMS)-CPS database. For missing state-years (early 1970s and late 1960s for a few states), this measure is supplemented with data from the IPUMS-USA database.[13] The results show that my finding that firms decrease leverage following the passage of the good faith exception is robust to controlling for state-level unemployment rates. In addition, the negative relation between unemployment rates and leverage is consistent with the finding in Agrawal and Matsa (2013) that leverage is negatively associated with worker unemployment risk. Specifically, higher unemployment rates imply that it is more difficult for unemployed employees to find work, which also suggests higher unemployment risk.

Second, states with right-to-work laws are considered less labor friendly and therefore may be less likely to adopt labor protection laws and more likely to have firms with lower leverage ratios headquartered in their state (Dertouzos and Karoly (1992); Matsa (2010)). In

[13] The IPUMS-CPS database compiles data from the March CPS each year since 1962. The CPS is a monthly U.S. household survey conducted jointly by the U.S. Census Bureau and the Bureau of Labor Statistics. The March survey covers additional topics compared to the surveys conducted in other months and is therefore the most widely used. The IPUMS-USA database compiles data from the American population federal censuses every ten years. For the census years 1980 and 1990, I use the 1-in-20 national random sample of the population. For the year 1970, I use the 1-in-100 national random sample of the population. Since my sample ranges from 1967 to 1995 and census years are available for 1970, 1980, and 1990, I assume that the values from the 1970, 1980, and 1990 censuses are valid for the 1967-1975, 1976-1985, and 1986-1995 periods, respectively.

addition, fewer employees may elect representation by unions following the adoption of WDLs because the protection of nonunionized workers increases relative to the protection provided by unions. Matsa (2010) shows that firms use more financial leverage in the presence of organized labor. Consequently, decreases in debt ratios following the passage of these laws could reflect lower union membership rather than higher firing costs. To control for these two factors, column 2 includes an indicator variable for whether the state where the firm is headquartered has passed right-to-work laws as of year *t* and state-level union membership as additional control variables. State-level union membership is the fraction of each state's nonagricultural wage and salary employees who are covered by a collective bargaining agreement.[14] Inconsistent with changes in union membership or other labor laws driving my findings, the results in column 2 show that the negative relation between leverage and the enactment of the good faith exception is robust to controlling for these two variables.

Third, Dertouzos and Karoly (1992) and Bird and Smythe (2008) argue that a court's decision to adopt WDLs is influenced by whether neighboring states and states that belong to the same federal circuit region have already enacted these laws. Thus, to control for the influence of the strength of labor protection laws in neighboring states, column 3 includes variables that measure the fraction of bordering states that have passed the good faith, implied contract, and public policy exceptions by year *t* as additional regressors.[15] The results in column 3 continue to show a negative relation between debt financing and the adoption of the good faith exception, suggesting that omitted variables related to the influence of the strength of labor laws in neighboring states do not drive my findings.

Lastly, Autor (2003) and Autor, Kerr, and Kugler (2007) find that following the passage of WDLs, firms employ more temporary workers and shift from relatively more expensive labor inputs to less labor-intensive capital investments to reduce their exposure to litigation and

[14] Data on state union membership are from Hirsch, Macpherson, and Vroman (2001) and are available online at http://www.unionstats.com. Data on the passage of right-to-work laws are from the Department of Labor and are available at http://www.dol.gov/whd/state/righttowork.htm.

[15] Because Alaska and Hawaii do not have any bordering states, in columns 3 and 4, I drop all observations for firms that are headquartered in these two states. This restriction reduces the sample size from 81,161 observations to 81,006 observations.

employee firing costs. Thus, to control for the effects of a changing labor force and operations, column 4 further controls for the fraction of a firm's workers that are full-time employees and its labor-to-asset ratio. I proxy for a firm's fraction of full-time workers with the fraction of employees that work at least 40 hours per week in the firm's 3-digit North American Industry Classification System (NAICS) industry within its headquarters state. I obtain worker hours from the IPUMS-USA database. The labor-to-asset ratio is the number of a firm's employees to its real book value of assets, where book values of assets are converted into 2009 dollars. The results in column 4 show that the finding that debt ratios decrease following the passage of the good faith exception is robust to controlling for these two variables.

Overall, the results in Table IV are inconsistent with the alternative explanation that omitted variables related to local economic conditions or changes firms make to their operations or the type of workers they employ explain my findings. Thus, these findings provide additional evidence that the passage of WDLs is exogenous with respect to firms' capital structure decisions.

5.2.2. The Timing of Capital Structure Changes

Following Bertrand and Mullainathan (2003), I next conduct an additional test to help alleviate potential endogeneity concerns related to reverse causality. To do so, I examine the timing of financial leverage changes relative to the timing of the passage of the good faith exception. If reverse causality is an issue, then there would be a trend of declining leverage before the enactment of this law. Further, if a trend exists before the passage of the good faith exception, this finding would cast doubt on the validity of using a difference-in-differences approach because it would suggest a violation of the parallel trends assumption.[16]

To check for pre-existing trends in financial leverage, I replace the variable for whether the state where a firm is headquartered has adopted the good faith exception as of year *t* with the

[16] The "parallel trends" condition in my empirical setting means that in the absence of treatment (the passage of WDLs), the average change in financial leverage ratios would have been the same for both the treatment group (firms headquartered in states that have adopted WDLs) and the control group (firms headquartered in states that have not adopted WDLs). If the treatment and control groups follow different trends before the enactment these laws, then inferences are generally inconclusive. Specifically, the estimated effect of the passage of WDLs is biased in an unknown direction.

following variables: *Good Faith*$^{-1}$, *Good Faith*^{0}, *Good Faith*^{1}, and *Good Faith*$^{2+}$. These four variables are indicator variables set to one if the firm is headquartered in a state that (1) will pass the good faith exception in one year, (2) passes the good faith exception in the current year, (3) passed the good faith exception one year ago, and (4) passed the good faith exception two or more years ago.[17] The estimated coefficient on the indicator variable *Good Faith*$^{-1}$ is especially important because its significance and magnitude would indicate if there is any relation between financial leverage and the good faith exception before the enactment of this law. Specifically, a negative and statistically significant coefficient would imply that the decline in leverage preceded the law, which would cast doubt on the exogeneity of the passage of the good faith exception.

The results in column 1 of Table V imply that there is no trend of declining book leverage before the adoption of the good faith exception. The coefficient estimates on *Good Faith*$^{-1}$ and *Good Faith*^{0} are small and statistically insignificant. The coefficient estimates on *Good Faith*^{1} and *Good Faith*$^{2+}$ are statistically significant and about three times as large as the estimate on *Good Faith*^{0}, which strongly suggests that book leverage declined only after the enactment of the good faith exception.

Column 2 shows a similar pattern for market leverage. However, the significant coefficient estimate on only *Good Faith*$^{2+}$ implies that market leverage does not decline until two years after the passage of the good faith exception. Overall, the finding in Table V that debt ratios decline only after the enactment of the good faith exception and not before suggests that the relation does not suffer from reverse causality. Further, the result confirms the use of a difference-in-differences approach, as it shows that firms located in states that pass and that do not pass the good faith exception follow parallel trends before its adoption.

5.3. Cross-Sectional Tests of Wrongful Discharge Laws and Financial Leverage

I next conduct cross-sectional tests that exploit settings where the effect of the passage of

[17] There are two instances in which a state reversed its previous passage of the good faith exception. These reversals are: (1) New Hampshire reversing the passage of the good faith exception in 1980 and (2) Oklahoma reversing the passage of the good faith exception in 1989. To account for these reversals, I drop all observations for these two states after the date of the reversal, which reduces the sample size from 81,161 observations to 80,635 observations.

WDLs on debt ratios is expected to be larger. In addition to shedding light on the economic mechanisms behind my results, these tests further alleviate endogeneity concerns and in particular, the concern of a correlated omitted variable. For an omitted variable to explain my findings, in addition to being uncorrelated with controls for local economic conditions and firm characteristics, it would also have to explain and be consistent with all of my cross-sectional findings.

5.3.1. The Effect of Labor Market Characteristics

If firms lower debt ratios in response to higher firing costs, then the negative relation between the adoption of WDLs and firms' leverage ratios should be especially strong for firms whose workers are more likely protected by these laws and more likely to file wrongful termination lawsuits. To test this prediction, I consider four scenarios. First, firms that employ more full-time workers are more likely to incur increases in expected firing costs due the passage of WDLs, as these laws are less applicable to temporary workers (Miles (2000); Autor (2003)). Thus, I examine whether my results are especially strong for firms that employ more full-time workers. To do so, I create subsamples that are formed on the basis of the fraction of a firm's workers that are employed full-time, proxied for by the fraction of workers in a firm's 3-digit NAICS industry within its headquarters state that work at least 40 hours a week.

Second, Dertouzos, Holland, and Ebener (1988) find that plaintiffs in wrongful discharge cases typically earn considerably higher wages. Autor, Donohue, and Schwab (2006) also argue that because damage awards tend to be roughly proportional to prior earnings, high-wage workers have a greater incentive to litigate, and attorneys working on a contingency basis have a greater incentive to take their cases. Consequently, I also examine whether my findings are stronger for firms whose workers likely receive higher wages. Here, I create subsamples that are based on the average wages received by a firm's workers, measured as the mean wage of employees in the firm's 3-digit NAICS industry within its headquarters state.

Third, anecdotal evidence suggests that during hard economic times when the unemployment rate is higher, workers are substantially more likely to file wrongful termination

lawsuits, as the unemployed burn through their savings and run up debt.[18] Thus, I investigate whether my findings are especially strong when the unemployment rate is higher in a firm's headquarters state.

Lastly, I divide the sample based on the likelihood that a firm's employees are covered by a collective bargaining agreement. The motivation behind this sample split is that these laws generally pertain to workers not covered by collective bargaining agreements and are therefore less likely to affect firms whose employees are represented by labor unions (Miles (2000)). To proxy for a firm's unionization rate, I use the unionization rate of the state where the firm is headquartered. However, because state unionization rates are a noisy proxy for a firm's or industry's unionization rate, I further limit the sample to only those industries with an above median fraction of workers in blue collar occupations. This additional restriction limits the sample to those industries most likely to have unions, as labor unions largely represent blue collar workers (Farber (1983)).

I separately estimate the impact of the passage of WDLs on debt ratios for firms with above and below sample median values of the previously discussed measures. Table VI presents the results of this analysis. The dependent variables in Panels A and B are book and market leverage, respectively. The results show a negative relation between the adoption of the good faith exception and financial leverage only for firms whose workers are more likely protected by this law and in instances when employees are more likely to file wrongful termination claims against their employers.[19] For the samples used in the regressions in columns 1, 3, 5, and 7, the mean firm has book leverage of 24.0%, 23.8%, 24.4%, and 25.1%, respectively. Given these values, the coefficient estimates in columns 1, 3, 5, and 7 of Panel A suggest that firms whose

[18] See Carol J. Williams, "As Corporate Layoffs Rise, Legal Challenges are Likely to Follow," *Los Angeles Times*, December 22, 2008. The article notes that due to the recent financial crisis, labor and employment lawyers warn that a tidal wave of wrongful termination lawsuits are expected in the coming months, as the jobless burn through their savings, run up debt, and find few work prospects in the worst economic downturn in decades. Attorneys specializing in labor law say that they have not been this busy since the late 1980s, as strapped corporate clients seek their counsel on how to reduce staff without inviting litigation.

[19] The estimated coefficients on *Good Faith* across the sample splits (in both Tables VI and VII) are not always statistically different at conventional levels. Nevertheless, the overall pattern of larger estimated coefficients and a statistically significant negative relation between financial leverage and *Good Faith* for only the subsamples of firms that face larger increases in expected firing costs due to the adoption of the law supports the hypothesis that an increase in firing costs causes firms to lower debt ratios.

workers are more likely protected by the good faith exception and more likely to file wrongful termination lawsuits reduce book leverage by 9.6% (=0.023 / 0.240), 10.5% (=0.025 / 0.238), 7.8% (=0.019 / 0.244), and 18.3% (=0.046 / 0.251) following the enactment of the good faith exception, respectively. Overall, the results in Table VI further strengthen my conclusion that an increase in firing costs causes firms to use less financial leverage.

5.3.2. The Effect of the Propensity to Lay Off Workers

Firms that have a greater tendency to dismiss workers are more likely subject to wrongful termination lawsuits and therefore face higher expected firing costs. Thus, the negative relation between the passage of WDLs and financial leverage should also be stronger for firms that are more likely to dismiss workers.

To test this prediction, I create subsamples based on a firm's layoff propensity rate and likelihood of becoming financially distressed. I create two measures for a firm's layoff propensity rate. For the first proxy, I calculate the fraction of firms in each firm's 3-digit NAICS industry that reduce their number of employees during a fiscal year by at least 5% and average this measure over the previous ten years.[20] For the second measure, I use the layoff propensity measure provided in Agrawal and Matsa (2013). This measure is based on the average annual fraction of workers separated from work as part of a mass layoff. The measure uses data from the U.S. Bureau of Labor Statistics' (BLS) "Mass Layoff Statistics" and the U.S. Bureau of Economic Analysis (BEA) and is based on 3-digit NAICS industries over all of the years when the data are available (1996–2008).[21] I then use this variable as a single industry measure for the

[20] I calculate the one-year change in each firm's number of employees using data from Compustat. Since Compustat only provides the aggregate number of a firm's employees across all of its divisions, a decrease in the number of a firm's employees does not necessarily imply that the firm laid off these employees. It is possible that I would also observe a decrease in the number of a firm's employees if it sells a division to another firm. If selling a division to another firm does not result in a greater likelihood of layoffs or wrongful termination lawsuits, then using Compustat data to calculate employee layoffs could be a noisy proxy for the firm's propensity to lay off workers and the increase in firing costs that the firm faces. Such measurement error may attenuate my results.

[21] Agrawal and Matsa (2013) count the number of workers who are separated from their jobs during extended mass layoffs, which is defined by the BLS as when at least 50 initial claims for unemployment insurance are filed against an establishment during a consecutive 5-week period and at least 50 workers have been separated from their jobs for more than 30 days. For each industry-year, they take the ratio of such separations to total industry employment (from the BEA) and then obtain the industry layoff separation rate by taking the simple average of these ratios over the full sample period.

entire sample period from 1967 to 1995.

To capture the likelihood that a firm will become financially distressed and will need to lay off workers to meet outstanding debt obligations, I calculate the firm's modified Altman z-score. This measure excludes financial leverage from its calculation, which helps mitigate confounding effects from using leverage as the dependent variable in the regression models.

I separately estimate the impact of the passage of WDLs on financial leverage for firms with above and below sample median layoff propensity rates and modified Altman z-scores and present the results in Table VII. The dependent variable in Panel A is book leverage, and the dependent variable in Panel B is market leverage. The results show a negative relation between the adoption of the good faith exception and financial leverage only for firms that face above median layoff propensity rates and below median z-scores. For the samples used in the regressions in columns 1, 3, and 5, the mean firm has book leverage of 24.6%, 24.4%, and 31.2%, respectively. Given these values, the coefficient estimates in columns 1, 3, and 5 of Panel A suggest that following the enactment of the good faith exception, firms with higher layoff propensity rates and higher likelihoods of defaulting reduce book leverage by 13.4% (=0.033 / 0.246), 9.8% (=0.024 / 0.244), and 7.7% (=0.024 / 0.312), respectively. In sum, the results in Table VII suggest that firms that are more likely to lay off workers are more likely to take into account firing costs when making capital structure decisions, as expected firing costs are greater for these firms.

5.4. Wrongful Discharge Laws and Operating Leverage

I argue that higher firing costs result in lower financial leverage ratios by increasing the costs of financial distress and/or increasing operating leverage. The first effect is difficult to test empirically because higher firing costs affect the *expected* costs of financial distress in the event the firm becomes distressed. The second effect is also challenging to test due to limitations in empirically estimating measures of operating leverage. Typically, proposed proxies of operating leverage require using data over several consecutive years (e.g., Mandelker and Rhee (1984); Kahl, Lunn, and Nilsson (2013)). It would be problematic to use such measures in the context of

my difference-in-differences research design, which measures the average treatment effect from the passage of WDLs over time. However, if higher firing costs increase operating leverage, then I should observe that firms are less likely to lay off workers following negative cash flow shocks after the adoption of WDLs.

In this section, I empirically test this prediction and present the results in Table VIII. I create one continuous measure and two discrete measures to capture employee layoffs. In column 1, I follow Hanka (1998) and define the dependent variable as the percentage decline in the number of a firm's employees over the previous year, with employment gains (positive percentage changes) set to zero. In columns 2 and 3, I follow Atanassov and Kim (2009) and define the dependent variable as an indicator variable set to one if the number of a firm's employees is at least 20% lower relative to the previous year and zero otherwise.[22] In columns 4 and 5, I use a lower cutoff point and define the dependent variable as an indicator variable set to one if the decrease in the number of a firm's employees is at least 15% and zero otherwise. In this sample, firms lay off at least 20% (15%) of their employees in 8.8% (12.2%) of firm years.

I also create one continuous measure and two discrete measures for cash flow shocks. I define *% Decline in Operating Income* as the percentage decline in operating income before depreciation over the previous year, with operating income gains (positive percentage changes) set to zero. For the discrete measure, *Shock 50% (Shock 25%)* is an indicator variable set to one if operating income before depreciation in the current year is at least 50% (25%) lower than in the previous year. To account for instances when negative cash flows occur in the denominator, I use the absolute value of the previous year's operating income before depreciation in the denominator. Firms experience a 50% (25%) negative cash flow shock in 12.9% (20.3%) of firm years.

The results in all five columns of Table VIII show that firms are less likely to lay off employees following negative cash flow shocks after the passage of the good faith exception. For

[22] Because I calculate layoffs as the change in the number of employees reported by a firm using data from Compustat, I would also observe a decrease in the number of employees if the firm sells a division. To address this concern, I rerun the regressions in Table VIII and also include control variables for contemporaneous and lagged changes in a firm's asset base to control for changes in the firm's number of employees due to asset sales. I find quantitatively similar results.

example, the coefficient estimates in column 2 imply that the probability that a firm lays off at least 20% of its employees following at least a 50% negative cash flow shock is 8.3% before the enactment of this law. However, following the adoption of the law, this probability shrinks to 5.5% (=0.083 - 0.028), a 33.7% reduction. Overall, the results in Table VIII are consistent with higher firing costs increasing firms' operating leverage.

5.5. Wrongful Discharge Laws and Cash Policies

In my last set of analyses, I examine whether an increase in firing costs also impacts a firm's cash policies. If an increase in firing costs raises a firm's financial distress costs and operating leverage, the firm may hold more cash to reduce the risk of becoming financially distressed and the likelihood of resorting to costly layoffs to cover cash flow shortfalls.

Table IX presents the results of this analysis.[23] The dependent variable in column 1 is the natural logarithm of the book value of cash and short-term investments divided by the book value of assets *(Log Cash Holdings)*. The dependent variable in column 2 is the natural logarithm of the book value of cash and short-term investments divided by the book value of assets less the book value of cash and short-term investments *(Log Net Cash Holdings)*. I include firm and year fixed effects and the set of control variables used in Opler, Pinkowitz, Stulz, and Williamson (1999). The results in columns 1 and 2 show that cash holdings increase following the passage of the good faith exception. In terms of economic significance, the coefficient estimates in column 1 (2) imply that firms increase cash holdings (net cash holdings) by 9.4% (9.9%) following the enactment of this law.[24]

If it is optimal for firms to increase their cash holdings in response to increases in firing costs, cash holdings should be more valuable to firms and investors following the passage of WDLs. To test this prediction, I follow the methodology in Faulkender and Wang (2006) and

[23] For the tests in Tables IX-XI that examine the relation between the adoption of the good faith exception and firms' cash management policies, the samples include all Compustat firm-year observations that have non-missing data for the relevant dependent and independent variables for each specific test. Thus, the base samples used in Tables IX-XI consist of 87,979, 71,183, and 87,004 firm-year observations, respectively.

[24] I compute the economic significance as follows. The increase in *Log Cash Holdings* of 0.090 log points corresponds to an increase in cash holdings of $e^{(0.090)}$-1 = 9.4%. Similarly, the increase in *Log Net Cash Holdings* of 0.094 log points corresponds to an increase in net cash holdings of $e^{(0.094)}$-1 = 9.9%.

estimate changes in firms' marginal value of cash following the adoption of the good faith exception. Table X presents the results of this analysis. The dependent variable in columns 1 and 2 is excess stock returns, which is a firm's annual stock return less the annual return of an equally-weighted benchmark portfolio matched on size and the book-to-market ratio. I calculate the control variables exactly as in Faulkender and Wang (2006) and include firm and year fixed effects in the regression models. To examine whether the marginal value of cash is higher following the passage of the good faith exception, I interact the annual change in cash holdings with the indicator variable *Good Faith.*

Column 1 shows a positive and statistically significant coefficient on the interaction term, suggesting that the marginal value of cash is higher following the adoption of the good faith exception. Specifically, the coefficient estimates in column 1 imply that following the passage of this law, the marginal value of cash increases from \$0.590 to \$0.755 (=0.590 + 0.165). The model in column 2 is the same as that in column 1, except that it allows changes in cash holdings to vary with the level of cash and with leverage. The results in column 2 continue to show that the marginal value of cash is higher following the enactment of the good faith exception. To estimate the marginal value of an additional dollar of cash in column 2, I use mean values of lagged cash holdings (17.7%) and market leverage (29.5%). Using these values, the coefficient estimates in column 2 imply that the marginal value of cash increases from \$0.737 (=0.952 - 0.263*0.177 - 0.571*0.295) to \$0.836 (=0.952 + 0.099 - 0.263*0.177 - 0.571*0.295) after the passage of the good faith exception.

Lastly, if firms increase their cash holdings when firing costs increase, one way they can do this is by saving more cash out of their cash flows following the passage of the good faith exception. To test this prediction, I follow the methodology in Almeida, Campello, and Weisbach (2004) and examine changes in a firm's cash flow sensitivity of cash following the adoption of this law.

Table XI presents the results of this analysis. The dependent variable in columns 1 and 2 is the change in a firm's book value of cash and short-term investments over the previous year divided by the beginning of year book value of assets. Following Almeida, Campello, and

Weisbach (2004), I define *Cash Flow* as income before extraordinary items and depreciation less the value of common and preferred dividends all divided by book value of assets. I also include firm and year fixed effects and the set of control variables used in Almeida, Campello, and Weisbach (2004). To investigate whether there are changes in firms' cash flow sensitivity of cash following the adoption of the good faith exception, I interact *Cash Flow* with the indicator variable *Good Faith.* A positive coefficient on the interaction term would suggest that firms save more cash out cash flows following the passage of this law. Column 2 also includes the control variable for acquisition related expenses that appears in the Almeida, Campello, and Weisbach (2004) model. However, the variable AQC in Compustat is only available beginning in 1971. Thus, column 2 restricts the sample period to 1971-1995.

The results in columns 1 and 2 show that firms save more cash out of their cash flows following the enactment of the good faith exception. In terms of economic significance, the estimated coefficients on the level and interaction term in column 1 imply that before the passage of this law, firms save \$0.358 per dollar of cash flow. Following the adoption of the good faith exception, however, this savings rate increases to \$0.453 (=0.358 + 0.095). The results in column 2 are similar, with firms saving \$0.357 per dollar of cash flow before the enactment of the law and \$0.450 (=0.357 + 0.093) after its passage. Overall, the Table IX-XI findings suggest that an increase in firing costs not only affects firms' debt financing policies but also impacts their cash management policies.

6. Additional Robustness Tests

6.1. Robustness to Dating Schemes for the Enactment of Wrongful Discharge Laws

There is some subjectivity in determining which court cases set the precedent that a state has adopted a particular WDL. This subjectivity results in various authors and studies using different dates for the passage of each employment at-will exception. For my analyses, I use the coding provided by Autor, Donohue, and Schwab (2006) with the exception that I also recognize Utah as passing the good faith exception in 1989. In this subsection, I examine the robustness of my main finding that leverage decreases following the adoption of the good faith exception to

using dating schemes and precedent setting cases provided in other studies. The alternative coding schemes that I analyze include the exact coding by Autor, Donohue, and Schwab (2006), Dertouzos and Karoly (1992), and Morriss (1995). Table XII tabulates the results of this analysis.

In columns 1-3, I first examine whether my findings are robust to using these alternative coding schemes over the 1967 to 1995 period to be consistent with my previous analyses. Because Dertouzos and Karoly (1992) and Morriss (1995) are earlier studies, they do not code Delaware as adopting the good faith and implied contact exceptions in 1992 or Wyoming as enacting the good faith exception in 1994. To account for this issue, I assume that these two studies would have coded these three events using the same precedent setting court cases and dates as Autor, Donohue, and Schwab (2006). However, in columns 4-6, I restrict the sample period to the years 1967 to 1991 so that these three events do not enter my sample period. The results in all six columns of Table XII show that the negative relation between leverage and the passage of the good faith exception is robust to using all three alternative coding schemes.

6.2. Robustness to Alternative Measures of Financial Leverage and Sample Periods

I also examine whether the observed decrease in debt ratios following the adoption of the good faith exception is robust to using alternative measures of financial leverage and sample periods. Table XIII tabulates the results of this analysis.

First, it is argued that cash can act like negative debt. Since firms can lower net leverage (debt less cash) by reducing debt or increasing cash holdings, Lambrecht and Pawlina (2012) and Kahl, Lunn, and Nilsson (2013) suggest that measuring financial leverage as net leverage provides greater insights into how firms make capital structure decisions. Consequently, I redefine book (market) leverage in column 1 (2) as total debt less cash and short-term investments divided by book value of assets (market value of assets).

Second, extant research suggests that ignoring operating lease commitments when calculating leverage ratios potentially understates a firm's true degree of leverage (Eisfeldt and Rampini (2009); Rauh and Sufi (2012)). Thus, I replace book (market) leverage in column 3 (4)

with debt plus the value of leases divided by book value of assets plus the value of leases (market value of assets plus the value of leases). To calculate the value of leases, I follow Rampini and Viswanathan (2013) and capitalize annual rental expenses at a 10% discount rate for all firms. The results in columns 1-4 show that the negative relation between leverage and the passage of the good faith exception is robust to measuring leverage net of cash and considering the value of leases in the leverage calculation.

As discussed in Section 4.1, my sample period ends before the last documented passage of the good faith exception in Louisiana in 1998. To examine whether ending the sample period earlier affects my results, in columns 5 and 6, I rerun my main leverage regressions using book and market leverage as the dependent variables but extend the sample period to five years after the last event to 2003. As an additional robustness check, I restrict the sample period in columns 7 and 8 to 1978-1999, which is the same as that used in Autor, Donohue, and Schwab (2006). Columns 5-8 show that, over both alternative sample periods, average leverage ratios decline following the adoption of the good faith exception.

6.3. Other Robustness Tests of the Main Specification

There is a potential drawback of using the passage of WDLs in the state where firms are headquartered as an exogenous source of variation in their firing costs. In particular, this methodology assumes that a majority of a firm's employees work in its headquarters state. However, to the extent that a firm has operations in multiple states or countries, the adoption of WDLs in its headquarters state may imprecisely capture its increase in firing costs. Further, because Compustat only provides the most current headquarters location, I am unable to identify if and when a firm moves its headquarters to a different state. Although such measurement error should only bias against finding a negative relation between the enactment of WDLs and financial leverage ratios, I next conduct additional robustness tests to investigate the extent to which such measurement error affects my findings. Table XIV presents the results of this analysis.

I first examine the robustness of my main leverage regressions to excluding firms with

operations in multiple states or countries. To do so, in column 1, I exclude observations when the firm reports non-missing and non-zero foreign income or foreign taxes. Similarly, I exclude all firms in industries in which a large percentage of the workforce is likely geographically dispersed in column 2. Dispersed industries include retail, wholesale, and transportation (Agrawal and Matsa (2013)). The results in these two columns show that the exclusion of these types of firms does not affect the finding that debt ratios decline following the passage of the good faith exception.

I next address the concern that firms may have switched headquarters locations during the sample period. To account for this issue, I first identify the firms in my sample that moved their headquarters to a different state during the years when I am able to determine the state where each firm is headquartered from 10-K filings using the programming language PHP. I am able to obtain this data for most firms between 1996 and 2011 and for some firms as early as 1992. I have headquarters data for 4,852 unique firms, and of these firms, 667 (13.7%) switch their headquarters state at least once. In column 3, I rerun my leverage regressions and eliminate all observations for these 667 firms.

A limitation of this sample restriction is that it only accounts for firms that moved their headquarters to a different state between 1992 and 2011. Thus, I next follow an approach similar to that in Amore, Schneider, and Žaldokas (2013) to eliminate observations for firms that likely switched locations during the earlier years in my sample. Specifically, for firm years when I am unable to collect headquarters data from 10-K filings, I compute each firm's one-year asset and sales growth rate. In column 4, in addition to excluding the same observations as in column 3, I exclude firms from the sample that had sales or assets grow by more than 100% in any year when 10-K data are unavailable. The finding in Pirinsky and Wang (2006) that mergers and acquisitions drive most headquarters relocations motivates this sample restriction. Because mergers are typically associated with large increases in sales or assets (Almeida, Campello, and Weisbach (2004)), the exclusion of firms with such growth exceeding 100% attempts to eliminate firms that may have experienced events that initiated changes in their headquarters locations. Together, columns 3 and 4 show that the finding that leverage decreases following the

adoption of the good faith exception is robust to excluding firms that may have relocated their headquarters.

Lastly, I address the potential concern that my findings may suffer from survivorship biases. In particular, if firms with higher debt ratios went bankrupt due to lawsuits related to violations of the good faith exception, there could be a mechanical decrease in average leverage ratios following the passage of this law. To account for potential survivorship biases, in column 5, I rerun my main leverage regressions and restrict the sample to only firms that survived and have Compustat data available for every year over the 1967 to 1995 period. This restriction reduces the sample size to 9,512 firm-year observations consisting of 328 firms. Using this sample, the results continue to show that firms reduce debt ratios following the adoption of the good faith exception.

7. Conclusion

This paper investigates how an exogenous increase in employee firing costs arising from the passage of U.S. state-level labor protection laws impacts firms' financial leverage policies. I hypothesize that higher firing costs lower firms' optimal amount of debt financing by directly increasing their financial distress costs and indirectly raising their operating leverage.

Consistent with this hypothesis, I find that firms respond to the passage of one particular wrongful discharge law—the good faith exception—by lowering financial leverage ratios. Moreover, the results from additional analyses suggest that reverse causality and omitted variables related to local economic conditions, changes in the types of workers that firms employ, and changes in the nature of firms' operations do not drive this finding. Further, in line with an increase in firing costs causing the decrease in debt ratios, the negative relation between the enactment of the good faith exception and leverage is especially strong: (1) for firms whose workers are more likely protected by these laws, (2) in instances when employees are more likely to file wrongful termination claims against their employers, and (3) for firms that have a higher likelihood of dismissing workers.

Lastly, I document that an increase in firing costs affects not only debt financing

decisions but also cash management policies. Specifically, following the adoption of the good faith exception, firms increase their cash holdings, and one way they do so is by saving more cash out of their cash flows. Further, I find that after the enactment of this law, investors place a higher value on each additional dollar of cash holdings, which supports the notion that it is optimal for firms to hold more cash to avoid the threat of costly layoffs.

In sum, my paper emphasizes the interdependence of firm financial policies with labor market frictions. In particular, my findings suggest that labor market frictions in the form of employee firing costs arising from the passage of labor protection laws have a significant impact on financing decisions. Thus, my study provides insights into how labor regulations, employee firing costs, and related litigation risk can affect financial policies.

Figure 1
Number of States Adopting Wrongful Discharge Laws

This figure shows the number of states that have passed the good faith, implied contract, and public policy exceptions to the traditional employment at-will rule in each year between 1959 and 1998.

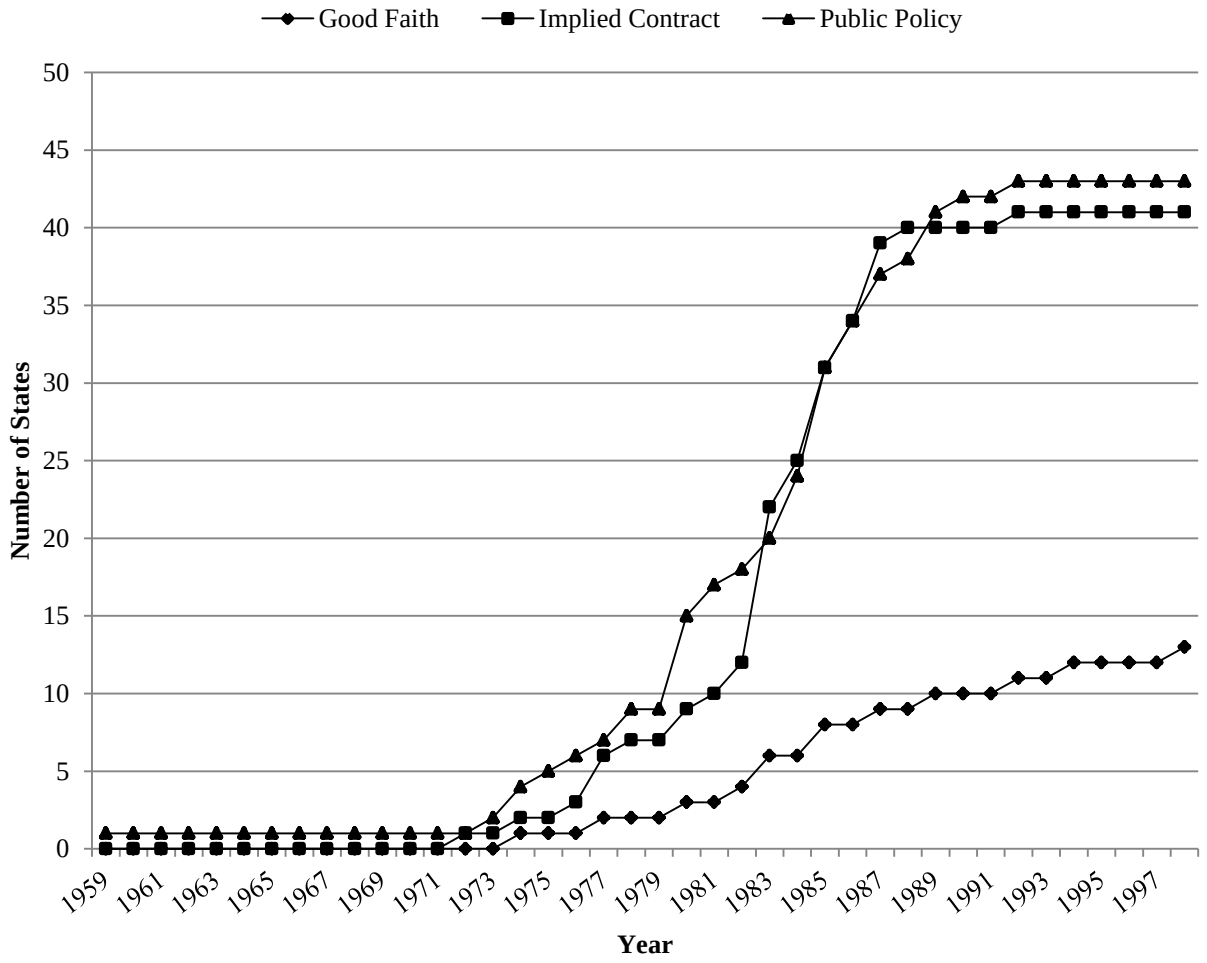

Table I
State-Level Wrongful Discharge Legislation

This table reports the month and year when each state passed the good faith, implied contract, and public policy exceptions to the traditional employment at-will rule.

State	Month/Year Good Faith Exception Passed	Month/Year Implied Contract Exception Passed	Month/Year Public Policy Exception Passed
Alabama		7/1987	
Alaska	5/1983	5/1983	2/1986
Arizona	6/1985	6/1983 (Reversed 4/1984)	6/1985
Arkansas		6/1984	3/1980
California	10/1980	3/1972	9/1959
Colorado		10/1983	9/1985
Connecticut	6/1980	10/1985	1/1980
Delaware	4/1992		3/1992
Florida	2/1983		
Georgia			
Hawaii		8/1986	10/1982
Idaho	8/1989	4/1977	4/1977
Illinois		12/1974	12/1978
Indiana		8/1987	5/1973
Iowa		11/1987	7/1985
Kansas		8/1984	6/1981
Kentucky		8/1983	11/1983
Louisiana	1/1998		
Maine		11/1977	
Maryland		1/1985	7/1981
Massachusetts	7/1977	5/1988	5/1980
Michigan		6/1980	6/1976
Minnesota		4/1983	11/1986
Mississippi		6/1992	7/1987
Missouri		1/1983 (Reversed 2/1988)	11/1985
Montana	1/1982	6/1987	1/1980
Nebraska		11/1983	11/1987
Nevada	2/1987	8/1983	1/1984
New Hampshire	2/1974 (Reversed 5/1980)	8/1988	2/1974
New Jersey		5/1985	7/1980
New Mexico		2/1980	7/1983
New York		11/1982	
North Carolina			5/1985
North Dakota		2/1984	11/1987
Ohio		4/1982	3/1990
Oklahoma	5/1985 (Reversed 2/1989)	12/1976	2/1989
Oregon		3/1978	6/1975
Pennsylvania			3/1974
Rhode Island			
South Carolina		6/1987	11/1985
South Dakota		4/1983	12/1988
Tennessee		11/1981	8/1984
Texas		4/1985	6/1984
Utah	3/1989	5/1986	3/1989
Vermont		8/1985	9/1986
Virginia		9/1983	6/1985
Washington		8/1977	7/1984
West Virginia		4/1986	7/1978
Wisconsin		6/1985	1/1980
Wyoming	1/1994	8/1985	7/1989

Table II
Summary Statistics

This table reports summary statistics for the main variables in the regression models. The sample consists of Compustat industrial firms (excluding financials and utilities) over the 1967 to 1995 period and includes 81,161 firm-year observations. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Variable definitions refer to Compustat designations where appropriate. *Book Leverage* is the book value of long-term debt plus *(dltt)* debt in current liabilities *(dlc)* divided by book value of assets *(at)*. *Market Leverage* is the book value of long-term debt *(dltt)* plus debt in current liabilities *(dlc)* divided by market value of debt and equity (long-term debt *(dltt)* plus debt in current liabilities *(dlc)* plus market value of equity *(prcc_f*csho))*. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *Assets* is the value of total book assets *(at)* in millions. *Market-to-Book* is the market value of assets (book value of assets *(at)* plus market value of equity *(prcc_f*csho)* minus book value of equity *(ceq))* divided by book value of assets *(at)*. *Profitability* is income before extraordinary items *(ib)* plus depreciation and amortization *(dp)* divided by book value of assets *(at)*. *Fixed Assets* is the ratio of property, plant, and equipment *(ppent)* to book value of assets *(at)*. *Cash Flow Volatility* is the standard deviation of *Profitability* over the previous ten years for each firm (firms are required to have at least three years of data to enter the calculation). *Dividend Payer* is an indicator variable set to one if a firm pays a common dividend *(dvc)* during a fiscal year and zero otherwise. *Modified Z-Score* is the modified Altman's z-score (1.2**(wcap/at)*+1.4**(re/at)* +3.3**(ebit/at)+(sale/at))*. *State GDP Growth* is the state-level GDP growth rate over the fiscal year.

	Mean	Std. Dev.	P25	Median	P75
Dependent Variables					
Book Leverage	0.25	0.19	0.10	0.23	0.36
Market Leverage	0.29	0.24	0.07	0.24	0.45
Main Explanatory Variables					
Good Faith	0.17	0.37	0.00	0.00	0.00
Implied Contract	0.52	0.50	0.00	0.00	1.00
Public Policy	0.54	0.50	0.00	1.00	1.00
Control Variables					
Assets	1343	7040	41.92	151.6	581.1
Market-to-Book	1.62	1.27	0.94	1.20	1.75
Profitability	0.05	0.16	0.04	0.09	0.13
Fixed Assets	0.33	0.21	0.17	0.29	0.45
Cash Flow Volatility	0.08	0.11	0.02	0.04	0.08
Dividend Payer	0.48	0.50	0.00	0.00	1.00
Modified Z-Score	2.06	1.96	1.43	2.36	3.11
State GDP Growth	0.08	0.04	0.06	0.08	0.10

Table III
Wrongful Discharge Laws and Financial Leverage

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith, Implied Contract,* and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively. The critical t-values (two-tailed with 49 degrees of freedom) for significance at the 10%, 5%, and 1% level is 1.68, 2.01, and 2.68, respectively.

Panel A: Dependent Variable is Book Leverage

	(1)	(2)	(3)	(4)
Good Faith	-0.014**			-0.015**
	(-2.48)			(-2.51)
Implied Contract		-0.001		-0.003
		(-0.32)		(-0.90)
Public Policy			0.002	0.003
			(0.63)	(0.85)
Log Assets	0.046***	0.046***	0.046***	0.046***
	(14.98)	(15.01)	(15.07)	(15.02)
Market-to-Book	-0.007***	-0.007***	-0.007***	-0.007***
	(-5.66)	(-5.63)	(-5.62)	(-5.66)
Profitability	-0.071***	-0.071***	-0.071***	-0.071***
	(-4.58)	(-4.61)	(-4.61)	(-4.59)
Fixed Assets	0.197***	0.197***	0.197***	0.197***
	(12.47)	(12.46)	(12.46)	(12.47)
Cash Flow Volatility	0.032	0.032	0.032	0.032
	(1.10)	(1.10)	(1.10)	(1.10)
Dividend Payer	-0.051***	-0.052***	-0.051***	-0.051***
	(-13.63)	(-13.52)	(-13.58)	(-13.65)
Modified Z-Score	-0.043***	-0.043***	-0.043***	-0.043***
	(-21.09)	(-20.93)	(-20.99)	(-21.08)
State GDP Growth	0.038	0.033	0.033	0.037
	(1.54)	(1.34)	(1.42)	(1.59)
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,161	81,161
Adjusted R^2	0.699	0.699	0.699	0.699

Table III - *(Continued)*

Panel B: Dependent Variable is Market Leverage

	(1)	(2)	(3)	(4)
Good Faith	-0.013**			-0.013**
	(-2.42)			(-2.64)
Implied Contract		-0.001		-0.002
		(-0.17)		(-0.55)
Public Policy			0.003	0.003
			(0.74)	(0.90)
Log Assets	0.055***	0.055***	0.055***	0.055***
	(14.15)	(14.18)	(14.19)	(14.18)
Market-to-Book	-0.045***	-0.045***	-0.045***	-0.045***
	(-13.85)	(-13.85)	(-13.86)	(-13.83)
Profitability	-0.152***	-0.153***	-0.153***	-0.152***
	(-5.58)	(-5.61)	(-5.60)	(-5.58)
Fixed Assets	0.184***	0.184***	0.184***	0.184***
	(11.97)	(11.97)	(11.96)	(11.97)
Cash Flow Volatility	-0.027	-0.027	-0.027	-0.027
	(-0.82)	(-0.82)	(-0.82)	(-0.82)
Dividend Payer	-0.080***	-0.080***	-0.080***	-0.080***
	(-19.26)	(-19.03)	(-19.02)	(-19.25)
Modified Z-Score	-0.042***	-0.042***	-0.042***	-0.042***
	(-23.79)	(-23.70)	(-23.72)	(-23.75)
State GDP Growth	-0.216***	-0.221***	-0.221***	-0.217***
	(-4.29)	(-4.38)	(-4.52)	(-4.45)
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,161	81,161
Adjusted R^2	0.732	0.732	0.732	0.732

Table IV
Effect of Potential Omitted Variables

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *State Unemployment Rate* is the fraction of workers within a state that are in the labor force but unemployed. *Right-to-Work Law* is an indicator variable set one if a firm is headquartered in a state that has passed right-to-work laws by year *t* and zero otherwise. *State Union Membership* is the fraction of each state's nonagricultural wage and salary employees who are covered by a collective bargaining agreement. *Bordering States' Good Faith*, *Bordering States' Implied Contract*, and *Bordering States' Public Policy* are the fraction of states that border the state where a firm is headquartered that have passed the good faith, implied contract, and public policy exceptions by year *t*, respectively. *Full-Time Workers* is the fraction of employees that work at least 40 hours per week grouped by 3-digit NAICS industries and state. *Labor-to-Assets* is the number of employees *(emp)* to the real book value of assets *(at)*, where book values of assets are converted into 2009 dollars. Control variables include *Log Assets*, *Market-to-Book*, *Profitability*, *Fixed Assets*, *Cash Flow Volatility*, *Dividend Payer*, *Modified Z-Score*, and *State GDP Growth*. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

Panel A: Dependent Variable is Book Leverage				
	(1)	(2)	(3)	(4)
Good Faith	-0.017***	-0.016***	-0.013**	-0.012**
	(-2.78)	(-2.69)	(-2.33)	(-2.12)
Implied Contract	-0.002	-0.002	-0.002	-0.002
	(-0.61)	(-0.59)	(-0.77)	(-0.58)
Public Policy	0.003	0.003	0.002	0.003
	(1.09)	(1.02)	(0.67)	(1.04)
State Unemployment Rate	-0.145***	-0.146***	-0.136**	-0.140***
	(-2.70)	(-2.68)	(-2.56)	(-2.68)
Right-to-Work Law		-0.004	-0.005	-0.005
		(-0.49)	(-0.64)	(-0.61)
State Union Membership		-0.083	-0.101*	-0.082
		(-1.61)	(-1.87)	(-1.57)
Bordering States' Good Faith			-0.009	-0.007
			(-1.03)	(-0.77)
Bordering States' Implied Contract			-0.014*	-0.010
			(-1.81)	(-1.48)
Bordering States' Public Policy			-0.008	-0.007
			(-1.13)	(-1.06)
Full-Time Workers				0.022
				(0.80)
Labor-to-Assets				0.205
				(0.79)
Control Variables	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,006	74,031
Adjusted R^2	0.699	0.699	0.699	0.701

Table IV - *(Continued)*

Panel B: Dependent Variable is Market Leverage				
	(1)	(2)	(3)	(4)
Good Faith	-0.014***	-0.013**	-0.013***	-0.011**
	(-2.76)	(-2.67)	(-2.90)	(-2.41)
Implied Contract	-0.002	-0.002	-0.002	-0.002
	(-0.51)	(-0.46)	(-0.42)	(-0.45)
Public Policy	0.003	0.003	0.003	0.003
	(0.92)	(0.91)	(0.84)	(1.04)
State Unemployment Rate	-0.033	-0.034	-0.029	-0.020
	(-0.52)	(-0.53)	(-0.43)	(-0.35)
Right-to-Work Laws		-0.017**	-0.016*	-0.014*
		(-2.24)	(-1.99)	(-1.97)
State Union Membership		-0.069	-0.084	-0.110
		(-0.92)	(-1.12)	(-1.54)
Bordering States' Good Faith			0.005	0.004
			(0.36)	(0.34)
Bordering States' Implied Contract			-0.009	-0.006
			(-0.91)	(-0.60)
Bordering States' Public Policy			-0.013	-0.011
			(-1.25)	(-1.08)
Full-Time Workers				-0.014
				(-0.50)
Labor-to-Assets				0.524*
				(1.83)
Control Variables	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,006	74,031
Adjusted R^2	0.732	0.732	0.732	0.736

Table V
Wrongful Discharge Laws and the Timing of Capital Structure Changes

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. The dependent variable in column 1 is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in column 2 is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith*$^{-1}$ is an indicator variable set to one if a firm is headquartered in a state that will pass the good faith exception in one year and zero otherwise. *Good Faith*^{0} is an indicator variable set to one if a firm is headquartered in a state that passes the good faith exception in the current year and zero otherwise. *Good Faith*^{1} is an indicator variable set to one if a firm is headquartered in a state that passed the good faith exception one year ago and zero otherwise. *Good Faith*$^{2+}$ is an indicator variable set to one if a firm is headquartered in a state that passed the good faith exception two or more years ago and zero otherwise. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	Book Leverage	Market Leverage
	(1)	(2)
Good Faith^{-1}	0.005	0.008
	(0.90)	(1.06)
Good Faith^{0}	-0.005	-0.009
	(-1.20)	(-1.12)
Good Faith^{1}	-0.016**	-0.009
	(-2.06)	(-1.43)
Good Faith^{2+}	-0.017**	-0.012**
	(-2.44)	(-2.06)
Implied Contract	-0.003	-0.002
	(-1.23)	(-0.63)
Public Policy	0.003	0.003
	(0.89)	(0.96)
Log Assets	0.046***	0.055***
	(14.91)	(14.11)
Market-to-Book	-0.007***	-0.045***
	(-5.63)	(-13.70)
Profitability	-0.070***	-0.154***
	(-4.52)	(-5.52)
Fixed Assets	0.196***	0.183***
	(12.26)	(11.80)
Cash Flow Volatility	0.030	-0.027
	(1.05)	(-0.81)
Dividend Payer	-0.051***	-0.080***
	(-13.54)	(-19.15)
Modified Z-Score	-0.043***	-0.042***
	(-20.82)	(-23.53)
State GDP Growth	0.038	-0.220***
	(1.65)	(-4.54)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Observations	80,635	80,635
Adjusted R^2	0.699	0.732

Table VI
Effect of Labor Market Characteristics

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *Full-Time Workers* is the fraction of employees that work at least 40 hours per week grouped by 3-digit NAICS industries and state. *Mean Worker Income* is the mean annual wage of all employees grouped by 3-digit NAICS industries and state. *State Unemployment Rate* is the fraction of workers within a state that are in the labor force but unemployed. *State Union Membership* is the fraction of each state's nonagricultural wage and salary employees who are covered by a collective bargaining agreement. *Blue Collar Industries* are industries with an above sample median fraction of workers employed in blue collar occupations grouped by 3-digit NAICS industries and state. Samples are divided into those with above and below sample median values for each particular measure. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

Panel A: Dependent Variable is Book Leverage

	Full Time Workers		Mean Worker Income		State Unemployment Rate		State Union Membership for Blue Collar Industries	
	Above Median (1)	Below Median (2)	Above Median (3)	Below Median (4)	Above Median (5)	Below Median (6)	Below Median (7)	Above Median (8)
Good Faith	-0.023***	-0.008	-0.025***	-0.011	-0.019***	-0.010	-0.046***	-0.006
	(-2.92)	(-0.73)	(-3.40)	(-1.36)	(-3.73)	(-1.14)	(-3.01)	(-0.87)
Implied Contract	-0.001	-0.002	-0.002	-0.002	0.001	-0.004	-0.004	0.001
	(-0.20)	(-0.47)	(-0.40)	(-0.42)	(0.21)	(-0.85)	(-0.57)	(0.48)
Public Policy	0.003	-0.002	0.008	-0.000	0.005	0.003	0.006	0.007
	(0.61)	(-0.32)	(1.65)	(-0.03)	(1.18)	(0.46)	(0.83)	(1.13)
Log Assets	0.051***	0.046***	0.044***	0.049***	0.048***	0.042***	0.057***	0.058***
	(15.84)	(8.41)	(13.28)	(11.41)	(12.73)	(10.05)	(11.98)	(7.55)
Market-to-Book	-0.007***	-0.006***	-0.006***	-0.008***	-0.006***	-0.007***	-0.006***	-0.011***
	(-3.98)	(-3.83)	(-3.71)	(-3.99)	(-3.04)	(-3.67)	(-2.73)	(-3.70)
Profitability	-0.050***	-0.083***	-0.067***	-0.069***	-0.058***	-0.075***	-0.071***	-0.092**
	(-2.69)	(-4.05)	(-4.22)	(-3.17)	(-3.06)	(-4.69)	(-3.10)	(-2.56)
Fixed Assets	0.189***	0.210***	0.210***	0.198***	0.215***	0.171***	0.172***	0.186***
	(9.30)	(10.14)	(11.16)	(10.52)	(9.44)	(9.02)	(6.41)	(5.87)
Cash Flow Volatility	0.128***	-0.056*	0.053	0.022	0.023	-0.003	0.092**	0.013
	(4.40)	(-1.85)	(1.52)	(0.49)	(0.49)	(-0.07)	(2.24)	(0.19)
Dividend Payer	-0.053***	-0.048***	-0.051***	-0.052***	-0.051***	-0.047***	-0.041***	-0.049***
	(-11.80)	(-9.50)	(-10.40)	(-9.56)	(-12.67)	(-8.42)	(-8.01)	(-7.57)
Modified Z-Score	-0.040***	-0.047***	-0.038***	-0.049***	-0.043***	-0.046***	-0.036***	-0.048***
	(-15.16)	(-15.82)	(-16.02)	(-13.47)	(-21.42)	(-13.65)	(-7.79)	(-11.42)
State GDP Growth	-0.021	0.030	-0.013	0.046	0.022	0.010	-0.050	0.057
	(-0.61)	(0.85)	(-0.33)	(1.65)	(0.55)	(0.17)	(-1.09)	(1.34)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	38,293	38,303	38,236	38,360	40,475	40,686	19,135	19,295
Adjusted R^2	0.682	0.744	0.691	0.735	0.720	0.724	0.700	0.717

Table VI - *(Continued)*

Panel B: Dependent Variable is Market Leverage

	Full Time Workers		Mean Worker Income		State Unemployment Rate		State Union Membership for Blue Collar Industries	
	Above Median	Below Median	Above Median	Below Median	Above Median	Below Median	Below Median	Above Median
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Good Faith	-0.023**	-0.004	-0.025***	-0.008	-0.025***	-0.001	-0.024*	-0.001
	(-2.25)	(-0.36)	(-3.50)	(-1.08)	(-4.74)	(-0.18)	(-1.88)	(-0.16)
Implied Contract	0.001	-0.004	-0.000	-0.003	-0.002	-0.006	0.005	0.002
	(0.16)	(-0.78)	(-0.05)	(-0.64)	(-0.48)	(-1.02)	(0.85)	(0.37)
Public Policy	0.002	-0.000	0.011**	0.000	0.008	-0.003	0.003	0.006
	(0.32)	(-0.06)	(2.61)	(0.04)	(1.46)	(-0.59)	(0.33)	(0.90)
Log Assets	0.062***	0.058***	0.054***	0.059***	0.061***	0.049***	0.069***	0.065***
	(14.60)	(7.27)	(13.63)	(9.73)	(13.11)	(11.50)	(12.15)	(7.82)
Market-to-Book	-0.042***	-0.042***	-0.036***	-0.053***	-0.046***	-0.042***	-0.041***	-0.057***
	(-10.60)	(-13.91)	(-11.95)	(-16.17)	(-8.18)	(-15.04)	(-8.66)	(-9.31)
Profitability	-0.125***	-0.162***	-0.119***	-0.201***	-0.129***	-0.168***	-0.164***	-0.245***
	(-4.41)	(-5.50)	(-4.30)	(-8.28)	(-4.02)	(-7.61)	(-5.73)	(-5.79)
Fixed Assets	0.191***	0.189***	0.205***	0.180***	0.205***	0.151***	0.155***	0.188***
	(10.57)	(9.03)	(10.60)	(8.85)	(9.53)	(7.26)	(7.00)	(4.59)
Cash Flow Volatility	0.068	-0.123***	0.012	-0.076*	-0.042	-0.046	0.014	-0.126**
	(1.56)	(-4.17)	(0.26)	(-1.70)	(-0.98)	(-1.11)	(0.30)	(-2.16)
Dividend Payer	-0.080***	-0.077***	-0.081***	-0.080***	-0.077***	-0.075***	-0.070***	-0.084***
	(-15.93)	(-14.01)	(-12.40)	(-13.38)	(-17.49)	(-12.41)	(-10.75)	(-13.77)
Modified Z-Score	-0.039***	-0.045***	-0.036***	-0.048***	-0.044***	-0.043***	-0.033***	-0.048***
	(-18.05)	(-16.67)	(-16.83)	(-14.49)	(-19.98)	(-13.87)	(-8.33)	(-8.18)
State GDP Growth	-0.289***	-0.140**	-0.282***	-0.151***	-0.186***	-0.186***	-0.248***	-0.087
	(-5.59)	(-2.50)	(-3.72)	(-3.88)	(-3.42)	(-2.78)	(-5.63)	(-1.19)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	38,293	38,303	38,236	38,360	40,475	40,686	19,135	19,295
Adjusted R^2	0.728	0.764	0.731	0.757	0.757	0.745	0.745	0.761

Table VII
Effect of the Propensity to Lay Off Workers

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith, Implied Contract,* and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *Industry Layoff Propensity* is the fraction of firms in a firm's 3-digit NAICS industry that reduce their number of employees during a fiscal year by at least 5%. This measure is averaged over the previous ten years to determine the industry's layoff propensity rate. *BLS Industry Layoff Propensity* is based on the average annual fraction of workers separated from work as part of a mass layoff. The measure uses data from the U.S. Bureau of Labor Statistics' (BLS) "Mass Layoff Statistics" and the U.S. Bureau of Economic Analysis (BEA) and is based on 3-digit NAICS industries over all of the years when the data are available (1996–2008). This measure is then used as a single industry measure for the entire sample period from 1967 to 1995. *Modified Z-Score* is the modified Altman's z-score (leverage excluded from calculation). Samples are divided into those with above and below sample median values for each particular measure. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

Panel A: Dependent Variable is Book Leverage

	Industry Layoff Propensity		BLS Industry Layoff Propensity		Modified Z-Score	
	Above Median	Below Median	Above Median	Below Median	Below Median	Above Median
	(1)	(2)	(3)	(4)	(5)	(6)
Good Faith	-0.033***	-0.000	-0.024***	-0.006	-0.024***	-0.006
	(-3.67)	(-0.06)	(-2.72)	(-0.63)	(-2.71)	(-0.85)
Implied Contract	-0.005	0.002	-0.002	-0.001	-0.010**	0.003
	(-1.30)	(0.46)	(-0.53)	(-0.43)	(-2.18)	(0.92)
Public Policy	0.000	0.003	0.004	-0.002	0.001	0.001
	(0.02)	(0.58)	(1.10)	(-0.28)	(0.21)	(0.20)
Log Assets	0.055***	0.046***	0.040***	0.051***	0.050***	0.016***
	(12.75)	(9.64)	(8.52)	(12.90)	(12.63)	(5.32)
Market-to-Book	-0.007***	-0.007***	-0.004*	-0.007***	-0.004*	-0.000
	(-3.89)	(-3.45)	(-1.95)	(-4.80)	(-1.98)	(-0.21)
Profitability	-0.068***	-0.049***	-0.071**	-0.057***	0.128***	0.098***
	(-3.51)	(-3.26)	(-2.45)	(-3.84)	(6.77)	(3.88)
Fixed Assets	0.213***	0.190***	0.165***	0.223***	0.200***	0.136***
	(10.18)	(9.54)	(6.79)	(12.68)	(13.24)	(5.87)
Cash Flow Volatility	0.085***	-0.004	0.114**	0.018	0.023	-0.025
	(3.05)	(-0.11)	(2.59)	(0.45)	(0.59)	(-0.65)
Dividend Payer	-0.051***	-0.042***	-0.052***	-0.049***	-0.050***	-0.028***
	(-11.94)	(-9.59)	(-10.62)	(-9.40)	(-10.49)	(-9.07)
Modified Z-Score	-0.038***	-0.053***	-0.044***	-0.042***	-0.049***	-0.081***
	(-17.95)	(-14.89)	(-13.50)	(-13.87)	(-17.94)	(-22.32)
State GDP Growth	-0.009	0.015	0.040	0.015	-0.015	0.038
	(-0.30)	(0.42)	(1.49)	(0.41)	(-0.46)	(1.40)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	39,574	39,609	35,110	37,493	40,580	40,581
Adjusted R^2	0.711	0.758	0.682	0.712	0.672	0.726

Table VII - *(Continued)*

Panel B: Dependent Variable is Market Leverage

	Industry Layoff Propensity		BLS Industry Layoff Propensity		Modified Z-Score	
	Above Median	Below Median	Above Median	Below Median	Below Median	Above Median
	(1)	(2)	(3)	(4)	(5)	(6)
Good Faith	-0.031**	-0.003	-0.022**	-0.009	-0.024***	-0.006
	(-2.68)	(-0.49)	(-2.62)	(-1.13)	(-3.11)	(-1.00)
Implied Contract	-0.005	0.000	0.001	-0.004	-0.006	0.001
	(-1.01)	(0.05)	(0.16)	(-0.91)	(-0.93)	(0.33)
Public Policy	-0.005	-0.001	0.003	0.002	0.003	0.000
	(-0.99)	(-0.19)	(0.54)	(0.35)	(0.37)	(0.08)
Log Assets	0.066***	0.059***	0.050***	0.058***	0.059***	0.020***
	(14.58)	(12.31)	(10.66)	(11.65)	(15.50)	(4.90)
Market-to-Book	-0.045***	-0.038***	-0.047***	-0.040***	-0.045***	-0.018***
	(-11.14)	(-13.32)	(-9.23)	(-11.92)	(-12.53)	(-7.46)
Profitability	-0.126***	-0.165***	-0.183***	-0.123***	0.026	-0.290***
	(-5.11)	(-5.84)	(-4.18)	(-5.21)	(1.49)	(-6.11)
Fixed Assets	0.198***	0.179***	0.142***	0.216***	0.181***	0.178***
	(11.15)	(9.05)	(6.07)	(11.05)	(12.02)	(6.56)
Cash Flow Volatility	0.046**	-0.118**	0.028	-0.040	-0.037	-0.166***
	(2.01)	(-2.31)	(0.54)	(-0.84)	(-0.90)	(-3.15)
Dividend Payer	-0.073***	-0.071***	-0.082***	-0.076***	-0.073***	-0.054***
	(-15.03)	(-12.85)	(-15.58)	(-11.96)	(-13.19)	(-13.35)
Modified Z-Score	-0.039***	-0.050***	-0.043***	-0.040***	-0.042***	-0.072***
	(-18.04)	(-18.34)	(-11.18)	(-14.64)	(-16.45)	(-15.75)
State GDP Growth	-0.228***	-0.240***	-0.169***	-0.304***	-0.357***	-0.074*
	(-4.64)	(-3.97)	(-3.21)	(-4.52)	(-6.33)	(-1.69)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	39,574	39,609	35,110	37,493	40,580	40,581
Adjusted R^2	0.738	0.781	0.728	0.740	0.730	0.767

Table VIII
Wrongful Discharge Laws and Employee Layoffs

This table reports the results from OLS regressions relating employee layoffs to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in column 1 is the percentage decline in a firm's number of employees *(emp_t / emp_{t-1} - 1)*, with employment gains (positive percentage changes) set to zero. The dependent variable in columns 2 and 3 is an indicator variable set to one if a firm reduces its number of employees *(emp_t / emp_{t-1} - 1)* by at least 20% and zero otherwise. The dependent variable in columns 4 and 5 is an indicator variable set to one if a firm reduces its number of employees *(emp_t / emp_{t-1} - 1)* by at least 15% and zero otherwise. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *% Decline in Operating Income* is the percentage decline in a firm's operating income before depreciation *($(oibdp_t - oibdp_{t-1})/|oibdp_{t-1}|$)*, with operating income gains (positive percentage changes) set to zero. *Shock 50%* is an indicator variable set to one if operating income before depreciation *(oibdp)* in the current year is at least 50% lower than in the previous year. *Shock 25%* is an indicator variable set to one if operating income before depreciation *(oibdp)* in the current year is at least 25% lower than in the previous year. In calculating percentage changes over the previous year, the absolute value of operating income before depreciation is used in the denominator. Control variables include *Log Assets*, *Market-to-Book*, *Profitability*, *Fixed Assets*, *Cash Flow Volatility*, *Dividend Payer*, *Modified Z-Score*, and *State GDP Growth*. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	% Decline in # of Employees	Lay Off More than 20% of Employees		Lay Off More than 15% of Employees	
	(1)	(2)	(3)	(4)	(5)
% Decline in Operating Income	0.008***				
	(8.19)				
Good Faith × % Decline in Operating Income	-0.004***				
	(-3.50)				
Shock 50%		0.083***		0.108***	
		(11.79)		(12.34)	
Good Faith × Shock 50%		-0.028***		-0.034***	
		(-3.08)		(-2.95)	
Shock 25%			0.063***		0.086***
			(10.11)		(10.79)
Good Faith × Shock 25%			-0.022**		-0.024**
			(-2.34)		(-2.38)
Good Faith	-0.007***	0.011*	0.012**	0.015***	0.015***
	(-3.18)	(1.93)	(2.23)	(2.80)	(2.80)
Implied Contract	0.001	-0.003	-0.003	-0.005	-0.005
	(0.82)	(-0.68)	(-0.64)	(-0.97)	(-0.92)
Public Policy	0.002	-0.004	-0.004	-0.005	-0.005
	(0.85)	(-0.80)	(-0.75)	(-0.78)	(-0.73)
Control Variables	Yes	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes
Observations	76,782	76,782	76,782	76,782	76,782
Adjusted R^2	0.250	0.186	0.185	0.186	0.186

Table IX
Wrongful Discharge Laws and Cash Holdings

This table reports the results from OLS regressions relating cash holdings to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in column 1 is *Log Cash Holdings*, which is the natural logarithm of the book value of cash and short-term investments *(che)* divided by book value of assets *(at)*. The dependent variable in column 2 is *Log Net Cash Holdings*, which is the natural logarithm of the book value of cash and short-term investments *(che)* divided by book value of assets *(at)* less the book value of cash and short-term investments *(che)*. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *Market-to-Book* is market value of assets (book assets *(at)* plus market value of equity *(prcc_f*csho)* minus book value of equity *(ceq))* divided by book value of assets *(at)*. *Log Assets* is the natural logarithm of book value of assets *(at)*. *Return on Assets* is operating income before depreciation *(oibdp)* divided by book value of assets *(at)*. *Net Working Capital* is working capital *(wcap)* less cash and short-term investments *(che)* divided by book value of assets *(at)*. *Capital Expenditures* is capital expenditures *(capx)* divided by book value of assets *(at)*. *Book Leverage* is book value of long-term debt *(dltt)* plus debt in current liabilities *(dlc)* divided by book value of assets *(at)*. *Industry Cash Flow Volatility* is the median of the standard deviations of *Return on Assets* over the previous twenty years for firms in the same two-digit SIC industries (at least three years of data are required). *R&D Expenditures* is R&D expenses *(xrd)* divided by sales *(sale)*. *Dividend Payer* is an indicator variable set to one if a firm pays a common dividend *(dvc)* during a fiscal year and zero otherwise. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	Log Cash Holdings	Log Net Cash Holdings
	(1)	(2)
Good Faith	0.090***	0.094***
	(3.36)	(3.14)
Implied Contract	0.019	0.018
	(0.67)	(0.63)
Public Policy	-0.007	-0.005
	(-0.27)	(-0.18)
Market-to-Book	0.067***	0.078***
	(12.49)	(11.90)
Log Assets	-0.019	-0.017
	(-0.77)	(-0.61)
Return on Assets	0.576***	0.699***
	(9.09)	(10.50)
Net Working Capital	-1.640***	-1.997***
	(-18.26)	(-19.05)
Capital Expenditures	-1.176***	-1.557***
	(-10.18)	(-11.81)
Book Leverage	-2.452***	-2.838***
	(-23.84)	(-23.60)
Industry Cash Flow Volatility	0.602	0.285
	(1.49)	(0.62)
R&D Expenditures	0.390***	0.595***
	(10.04)	(13.51)
Dividend Payer	0.015	0.011
	(0.56)	(0.37)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Observations	87,979	87,979
Adjusted R^2	0.604	0.636

Table X
Wrongful Discharge Laws and the Marginal Value of Cash

This table reports the results from OLS regressions relating the marginal value of cash to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in columns 1 and 2 is *Size and Book-to-Market Adjusted Abnormal Returns*, which is the firm's annual stock return less the annual return of an equally-weighted benchmark portfolio matched on size and the book-to-market ratio. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. The firm-level independent variables are: *Cash Holdings* (cash and short term investments *(che))*, *Earnings* (earnings before extraordinary items *(ibc)* plus interest *(xint)*, deferred tax credits *(txdi)*, and investment tax credits (*itci))*, *Net Assets* (total assets minus cash holdings *(at-che))*, *R&D Expenditures (xrd)*, *Interest Expense (xint)*, *Dividends* (common dividends paid *(dvc))*, *Market Leverage* (total debt *(dltt+dlc)* divided by total debt plus the market value of equity *(dltt+dlc+prcc_f*csho))*, and *Net Financing* (total equity issuances *(sstk)* minus repurchases *(prstkc)* plus debt issuances *(dltis)* minus debt redemptions *(dltr)).* These independent variables, except leverage, are divided by the lagged market value of equity. Changes are denoted by Δ and are calculated from year *t-1* to *t*. Continuous variables are trimmed at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	Size and Book-to-Market Adjusted Abnormal Returns	
	(1)	(2)
Δ Cash Holdings	0.590***	0.952***
	(20.12)	(21.32)
Δ Cash Holdings × Good Faith	0.165***	0.099**
	(3.17)	(2.41)
Good Faith	0.008	0.009
	(0.93)	(0.95)
Implied Contract	0.014	0.013
	(1.33)	(1.29)
Public Policy	0.003	0.003
	(0.33)	(0.32)
Δ Earnings	0.271***	0.270***
	(22.47)	(23.08)
Δ Net Assets	0.127***	0.130***
	(26.51)	(26.19)
Δ R&D Expenditures	0.523**	0.502**
	(2.63)	(2.52)
Δ Interest Expense	-0.704***	-0.691***
	(-8.74)	(-9.02)
Δ Dividends	1.802***	1.734***
	(6.08)	(5.74)
Lagged Cash Holdings	0.556***	0.538***
	(21.57)	(21.54)
Market Leverage	-0.630***	-0.623***
	(-25.37)	(-25.24)
Net Financing	0.033**	0.023
	(2.04)	(1.36)
Δ Cash Holdings × Lagged Cash Holdings		-0.263***
		(-6.24)
Δ Cash Holdings × Market Leverage		-0.571***
		(-8.47)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Observations	71,183	71,183
Adjusted R^2	0.166	0.170

Table XI
Wrongful Discharge Laws and the Cash Flow Sensitivity of Cash

This table reports the results from OLS regressions relating changes in cash holdings to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in columns 1 and 2 is *Change in Cash Holdings*, which is the change in book value of cash and short-term investments *(che)* over the previous year divided by the beginning of year book value of assets *(at)*. *Good Faith, Implied Contract,* and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. *Cash Flow* is income before extraordinary items and depreciation *(ib+dp)* less the value of common and preferred dividends *(dvc+dvp)* all divided by book value of assets *(at)*. *Market-to-Book* is the market value of assets (long-term debt *(dltt)* plus debt in current liabilities *(dlc)* plus market value of equity *(prcc_f*csho)* plus value of preferred stock *(pstkrv)* minus deferred taxes and investment tax credits *(txditc))* divided by book value of assets *(at)*. *Capital Expenditures* is capital expenditures *(capx)* divided by book value of assets *(at)*. *Change in Net Working Capital* is the change in net working capital *(wcap-che)* over the previous year divided by the beginning of year book value of assets *(at)*. *Net Debt Issuance* is long-term debt issuance *(dltis)* less long-term debt reduction *(dltr)* divided by book value of assets *(at)*. *Acquisition Expenses* is acquisition expenses *(aqc)* divided by book value of assets *(at)*. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	Change in Cash Holdings	
	(1)	(2)
Cash Flow	0.358***	0.357***
	(14.57)	(14.07)
Cash Flow × Good Faith	0.095**	0.093**
	(2.34)	(2.54)
Good Faith	-0.006	-0.008
	(-0.86)	(-1.21)
Implied Contract	-0.002	-0.004
	(-0.44)	(-0.61)
Public Policy	0.009*	0.009*
	(1.82)	(1.80)
Market-to-Book	0.028***	0.029***
	(20.95)	(20.46)
Log Assets	0.009**	0.014***
	(2.66)	(4.09)
Capital Expenditures	-0.551***	-0.622***
	(-12.12)	(-12.58)
Change in Net Working Capital	0.051*	0.059**
	(1.80)	(2.10)
Net Debt Issuance	0.122***	0.183***
	(6.24)	(9.83)
Acquisition Expenses		-0.522***
		(-9.26)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Observations	87,004	78,172
Adjusted R^2	0.290	0.295

Table XII
Alternative Dating Schemes for the Enactment of Wrongful Discharge Laws

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith, Implied Contract,* and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. Columns 1-3 use the full sample from 1967 to 1995. Columns 4-6 restrict the sample to the 1967 to 1991 period. Columns 1 and 4 define *Good Faith*, *Implied Contract*, and *Public Policy* using the precedent setting cases identified in Autor, Donohue, and Schwab (2006). Columns 2 and 5 define *Good Faith*, *Implied Contract*, and *Public Policy* using the precedent setting cases identified in Dertouzos and Karoly (1992). Columns 3 and 6 define *Good Faith*, *Implied Contract*, and *Public Policy* using the precedent setting cases identified in Morriss (1995). Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

Panel A: Dependent Variable is Book Leverage

	Full Sample Period: 1967-1995			Restricted Sample Period: 1967-1991		
	Autor, Donohue, and Schwab (2006)	Dertouzos and Karoly (1992)	Morriss (1995)	Autor, Donohue, and Schwab (2006)	Dertouzos and Karoly (1992)	Morriss (1995)
	(1)	(2)	(3)	(4)	(5)	(6)
Good Faith	-0.014**	-0.013**	-0.015**	-0.011*	-0.010*	-0.011**
	(-2.38)	(-2.19)	(-2.52)	(-1.93)	(-1.73)	(-2.08)
Implied Contract	-0.003	0.002	0.000	-0.002	0.000	0.000
	(-0.89)	(0.43)	(0.02)	(-0.71)	(0.09)	(0.08)
Public Policy	0.002	-0.001	0.001	0.003	0.000	0.003
	(0.78)	(-0.35)	(0.41)	(1.02)	(0.06)	(0.86)
Log Assets	0.046***	0.046***	0.046***	0.051***	0.051***	0.051***
	(15.02)	(15.17)	(15.06)	(17.84)	(18.01)	(17.89)
Market-to-Book	-0.007***	-0.007***	-0.007***	-0.007***	-0.007***	-0.007***
	(-5.65)	(-5.63)	(-5.65)	(-4.78)	(-4.77)	(-4.78)
Profitability	-0.071***	-0.071***	-0.071***	-0.076***	-0.076***	-0.076***
	(-4.59)	(-4.60)	(-4.59)	(-3.42)	(-3.43)	(-3.42)
Fixed Assets	0.197***	0.197***	0.197***	0.190***	0.190***	0.190***
	(12.47)	(12.48)	(12.48)	(11.56)	(11.55)	(11.55)
Cash Flow Volatility	0.032	0.031	0.031	0.047	0.046	0.046
	(1.10)	(1.09)	(1.10)	(1.19)	(1.18)	(1.18)
Dividend Payer	-0.051***	-0.051***	-0.051***	-0.046***	-0.046***	-0.046***
	(-13.65)	(-13.67)	(-13.63)	(-13.29)	(-13.31)	(-13.28)
Modified Z-Score	-0.043***	-0.043***	-0.043***	-0.048***	-0.048***	-0.048***
	(-21.09)	(-21.04)	(-21.08)	(-22.73)	(-22.69)	(-22.72)
State GDP Growth	0.036	0.035	0.038	0.030	0.029	0.032
	(1.56)	(1.42)	(1.59)	(1.21)	(1.13)	(1.25)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,161	65,201	65,201	65,201
Adjusted R^2	0.699	0.699	0.699	0.718	0.718	0.718

Table XII - *(Continued)*

Panel B: Dependent Variable is Market Leverage

	Full Sample Period: 1967-1995			Restricted Sample Period: 1967-1991		
	Autor, Donohue, and Schwab (2006)	Dertouzos and Karoly (1992)	Morriss (1995)	Autor, Donohue, and Schwab (2006)	Dertouzos and Karoly (1992)	Morriss (1995)
	(1)	(2)	(3)	(4)	(5)	(6)
Good Faith	-0.015***	-0.013**	-0.015***	-0.012**	-0.010*	-0.013**
	(-2.84)	(-2.35)	(-2.78)	(-2.61)	(-1.97)	(-2.52)
Implied Contract	-0.002	0.002	-0.002	-0.003	-0.001	-0.003
	(-0.60)	(0.47)	(-0.55)	(-0.79)	(-0.13)	(-0.68)
Public Policy	0.003	-0.002	0.001	0.004	-0.001	0.002
	(0.85)	(-0.64)	(0.14)	(1.09)	(-0.28)	(0.42)
Log Assets	0.055***	0.055***	0.055***	0.059***	0.059***	0.059***
	(14.17)	(14.22)	(14.17)	(13.68)	(13.72)	(13.67)
Market-to-Book	-0.045***	-0.045***	-0.045***	-0.045***	-0.045***	-0.045***
	(-13.83)	(-13.84)	(-13.83)	(-16.18)	(-16.19)	(-16.16)
Profitability	-0.152***	-0.152***	-0.152***	-0.174***	-0.174***	-0.174***
	(-5.58)	(-5.59)	(-5.59)	(-5.35)	(-5.36)	(-5.35)
Fixed Assets	0.184***	0.184***	0.184***	0.182***	0.182***	0.182***
	(11.97)	(11.97)	(11.97)	(10.34)	(10.34)	(10.32)
Cash Flow Volatility	-0.027	-0.027	-0.027	-0.054	-0.054	-0.054
	(-0.82)	(-0.83)	(-0.83)	(-1.40)	(-1.41)	(-1.41)
Dividend Payer	-0.080***	-0.080***	-0.080***	-0.076***	-0.076***	-0.076***
	(-19.23)	(-19.30)	(-19.23)	(-22.58)	(-22.65)	(-22.61)
Modified Z-Score	-0.042***	-0.042***	-0.042***	-0.048***	-0.048***	-0.048***
	(-23.76)	(-23.79)	(-23.79)	(-22.58)	(-22.60)	(-22.58)
State GDP Growth	-0.218***	-0.219***	-0.217***	-0.231***	-0.231***	-0.231***
	(-4.48)	(-4.12)	(-4.32)	(-5.12)	(-4.70)	(-4.93)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,161	65,201	65,201	65,201
Adjusted R^2	0.732	0.732	0.732	0.743	0.743	0.743

Table XIII
Alternative Measures of Financial Leverage and Sample Periods

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms. Variable definitions refer to Compustat designations where appropriate. The dependent variable in column 1 is *Net Book Leverage*, which is the book value of long-term debt *(dltt)* plus debt in current liabilities *(dlc)* less book value of cash and short-term investments *(che)* divided by book value of assets *(at)*. The dependent variable in column 2 is *Net Market Leverage*, which is the book value of long-term debt plus debt in current liabilities less book value of cash and short-term investments divided by market value of debt and equity (long-term debt plus debt in current liabilities plus market value of equity *(prcc_f*csho))*. The dependent variable in column 3 is *Book Leverage with Leases*, which is the book value of long-term debt plus debt in current liabilities plus the value of leases *(xrent*10)* divided by book value of assets plus the value of leases. The dependent variable in column 4 is *Market Leverage with Leases*, which is the book value of long-term debt plus debt in current liabilities plus the value of leases divided by market value of debt and equity plus the value of leases (long-term debt plus debt in current liabilities plus market value of equity plus value of leases). In columns 3 and 4, all control variables are adjusted to account for the value of leases by adding the value of leases to the book value of debt and/or assets. The value of leases is obtained by capitalizing annual rental expenses at a 10% discount rate. The dependent variable in columns 5 and 7 is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in columns 6 and 8 is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. Columns 1-4 use the full sample period from 1967 to 1995. Columns 5 and 6 use the sample period from 1967 to 2003. Columns 7 and 8 use the sample period from 1978 to 1999. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

	Sample Period: 1967-1995				Sample Period: 1967-2003		Sample Period: 1978-1999	
	Net Book Leverage	Net Market Leverage	Book Leverage with Leases	Market Leverage with Leases	Book Leverage	Market Leverage	Book Leverage	Market Leverage
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Good Faith	-0.028***	-0.024***	-0.015**	-0.014***	-0.013**	-0.010*	-0.026***	-0.017***
	(-3.74)	(-3.92)	(-2.42)	(-2.69)	(-2.25)	(-1.83)	(-5.25)	(-3.50)
Implied Contract	-0.003	0.000	-0.002	-0.001	-0.003	-0.002	-0.003	-0.002
	(-1.05)	(0.05)	(-0.94)	(-0.13)	(-0.87)	(-0.55)	(-0.76)	(-0.62)
Public Policy	0.003	0.003	0.003	0.003	0.005	0.005	0.002	0.001
	(0.69)	(0.68)	(1.23)	(0.75)	(1.47)	(1.46)	(0.34)	(0.19)
Log Assets	0.052***	0.072***	0.043***	0.052***	0.045***	0.051***	0.052***	0.061***
	(13.60)	(13.63)	(16.66)	(16.42)	(18.76)	(15.55)	(16.34)	(16.43)
Market-to-Book	-0.016***	-0.011***	-0.013***	-0.076***	-0.006***	-0.032***	-0.008***	-0.037***
	(-9.76)	(-2.73)	(-8.95)	(-28.73)	(-5.83)	(-9.18)	(-7.10)	(-10.24)
Profitability	-0.114***	-0.133***	-0.095***	-0.212***	-0.064***	-0.110***	-0.071***	-0.115***
	(-5.26)	(-4.00)	(-4.84)	(-8.24)	(-7.60)	(-6.68)	(-7.46)	(-6.93)
Fixed Assets	0.571***	0.543***	-0.040**	-0.037**	0.201***	0.198***	0.214***	0.204***
	(20.57)	(26.20)	(-2.22)	(-2.07)	(15.13)	(14.58)	(15.25)	(17.51)
Cash Flow Volatility	-0.026	-0.100**	-0.048	-0.095**	0.028***	-0.016	0.058**	0.021
	(-0.72)	(-2.51)	(-1.10)	(-2.10)	(2.85)	(-1.05)	(2.65)	(0.98)
Dividend Payer	-0.064***	-0.085***	-0.048***	-0.075***	-0.055***	-0.083***	-0.054***	-0.075***
	(-13.70)	(-15.88)	(-15.02)	(-19.49)	(-16.51)	(-19.90)	(-12.68)	(-15.09)
Modified Z-Score	-0.040***	-0.034***	-0.062***	-0.058***	-0.028***	-0.025***	-0.029***	-0.026***
	(-17.22)	(-18.86)	(-19.04)	(-18.84)	(-16.94)	(-14.29)	(-17.39)	(-17.00)
State GDP Growth	0.042	-0.158***	0.025	-0.219***	0.018	-0.251***	-0.012	-0.309***
	(1.28)	(-3.15)	(1.21)	(-3.99)	(0.82)	(-4.93)	(-0.44)	(-4.38)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	81,161	81,161	81,161	81,161	115,898	115,898	79,628	79,628
Adjusted R^2	0.741	0.668	0.767	0.789	0.673	0.701	0.688	0.718

Table XIV
Other Robustness Tests of the Main Specification

This table reports the results from OLS regressions relating financial leverage to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1995. Variable definitions refer to Compustat designations where appropriate. The dependent variable in Panel A is *Book Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by book value of assets. The dependent variable in Panel B is *Market Leverage*, which is the book value of long-term debt plus debt in current liabilities divided by market value of assets. *Good Faith*, *Implied Contract*, and *Public Policy* are indicator variables set to one if the state where a firm is headquartered has passed the good faith exception, the implied contract exception, and the public policy exception by year *t* and zero otherwise, respectively. Column 1 excludes all observations when a firm reports non-missing and non-zero foreign income *(pifo)* or foreign taxes *(txfo)*. Column 2 excludes all observations in which a firm is in a geographically dispersed industry. Dispersed industries include retail, wholesale, and transportation. Column 3 excludes all observations for firms that have moved their headquarters locations to different states in any of the years between 1992 and 2011. To identify firms that switch headquarters, I obtain each firm's state of headquarters information from their 10-K filings over the 1992 to 2011 period when it is available. Column 4 excludes the same observations as in column 3 and also excludes all observations for firms that have ever had a one-year increase in total assets *(at)* or total sales *(sale)* exceeding 100% in the years when I do not have headquarters data from 10-K filings. Column 5 restricts the sample to firms that have Compustat data available for every year over the 1967 to 1995 period. Table II provides definitions of control variables. Continuous variables are winsorized at their 1st and 99th percentiles, and dollar values are expressed in 2009 dollars. Standard errors are corrected for heteroskedasticity and clustering at the state level (t-statistics are in parentheses). *, **, and *** denote significance at the 10%, 5%, and 1% level, respectively.

Panel A: Dependent Variable is Book Leverage

	Exclude if firm has non-missing and non-zero foreign income or foreign taxes	Exclude firms in dispersed industries	Exclude if firm switches headquarters over 1992-2011	Exclude if firm switches headquarters over 1992-2011 or if growth exceeds 100%	Keep if firm survived entire 1967 to 1995 period
	(1)	(2)	(3)	(4)	(5)
Good Faith	-0.016**	-0.016**	-0.015**	-0.014*	-0.043***
	(-2.24)	(-2.55)	(-2.56)	(-1.93)	(-4.01)
Implied Contract	-0.002	-0.004	-0.002	-0.001	-0.004
	(-0.67)	(-1.18)	(-0.75)	(-0.25)	(-0.50)
Public Policy	-0.002	0.002	0.004	0.003	-0.003
	(-0.52)	(0.67)	(1.64)	(1.08)	(-0.38)
Log Assets	0.050***	0.048***	0.046***	0.036***	0.023***
	(13.10)	(18.91)	(15.08)	(9.37)	(2.94)
Market-to-Book	-0.007***	-0.006***	-0.007***	-0.003*	0.001
	(-4.83)	(-4.11)	(-5.64)	(-1.82)	(0.33)
Profitability	-0.080***	-0.074***	-0.073***	-0.068***	-0.260***
	(-5.00)	(-5.10)	(-4.42)	(-3.19)	(-3.65)
Fixed Assets	0.219***	0.202***	0.194***	0.166***	0.049
	(10.93)	(12.09)	(12.63)	(9.68)	(1.02)
Cash Flow Volatility	0.062*	0.058**	0.053**	-0.025	0.028
	(1.97)	(2.06)	(2.07)	(-0.76)	(0.10)
Dividend Payer	-0.051***	-0.050***	-0.049***	-0.044***	-0.032**
	(-12.64)	(-14.21)	(-12.38)	(-10.15)	(-2.50)
Modified Z-Score	-0.037***	-0.041***	-0.043***	-0.060***	-0.058***
	(-21.02)	(-17.63)	(-21.42)	(-24.04)	(-4.95)
State GDP Growth	0.030	0.039	0.042	0.061***	0.043
	(1.12)	(1.46)	(1.65)	(2.98)	(0.80)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes
Observations	56,596	65,950	75,036	55,373	9,512
Adjusted R^2	0.705	0.691	0.690	0.747	0.620

Table XIV - *(Continued)*

Panel B: Dependent Variable is Market Leverage

	Exclude if firm has non-missing and non-zero foreign income or foreign taxes	Exclude firms in dispersed industries	Exclude if firm switches headquarters over 1992-2011	Exclude if firm switches headquarters over 1992-2011 or if growth exceeds 100%	Keep if firm survived entire 1967 to 1995 period
	(1)	(2)	(3)	(4)	(5)
Good Faith	-0.015**	-0.014**	-0.013**	-0.015***	-0.044***
	(-2.24)	(-2.42)	(-2.40)	(-2.86)	(-2.95)
Implied Contract	-0.003	-0.001	-0.002	-0.001	0.005
	(-0.71)	(-0.30)	(-0.43)	(-0.37)	(0.63)
Public Policy	-0.004	0.002	0.004	0.003	-0.008
	(-0.87)	(0.58)	(1.34)	(0.82)	(-1.13)
Log Assets	0.059***	0.056***	0.055***	0.041***	0.033***
	(12.40)	(16.64)	(13.27)	(7.29)	(3.62)
Market-to-Book	-0.043***	-0.041***	-0.044***	-0.047***	-0.033***
	(-12.26)	(-13.33)	(-14.32)	(-15.95)	(-5.50)
Profitability	-0.141***	-0.143***	-0.153***	-0.203***	-0.638***
	(-5.53)	(-5.44)	(-5.44)	(-6.36)	(-5.08)
Fixed Assets	0.200***	0.172***	0.180***	0.174***	0.064
	(10.43)	(9.84)	(12.35)	(8.57)	(1.12)
Cash Flow Volatility	0.011	0.000	-0.022	-0.198***	-0.258
	(0.37)	(0.01)	(-0.80)	(-4.29)	(-0.74)
Dividend Payer	-0.079***	-0.078***	-0.079***	-0.072***	-0.080***
	(-17.16)	(-18.81)	(-18.50)	(-15.54)	(-6.39)
Modified Z-Score	-0.036***	-0.040***	-0.043***	-0.062***	-0.044***
	(-22.17)	(-19.49)	(-22.86)	(-21.45)	(-4.36)
State GDP Growth	-0.222***	-0.228***	-0.211***	-0.145***	-0.179*
	(-4.27)	(-3.89)	(-4.26)	(-3.73)	(-1.99)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes
Observations	56,596	65,950	75,036	55,373	9,512
Adjusted R^2	0.736	0.723	0.733	0.757	0.684

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