Effects of Customer Financial Distress on Supplier Capital Structure

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Abstract

We study how financial distress of a significant customer impacts capital structure of suppliers. Using a sample of U.S. firms that filed for Chapter 11 between 1980 and 2013, we find that the suppliers of these firms increase their leverage ratio over the two years prior to the filing date. This change is economically significant and consistent with the bargaining power theory, which states that an increase in suppliers' debt decreases the surplus available for negotiations. Therefore, suppliers increase their financing leverage to fortify their bargaining power with significant, distressed customers. We also find evidence that suppliers reduce their leverage after the customer reorganizes its liabilities and capital structure in the Chapter 11 process, indicating a return to a previous status quo.

Keywords: Bankruptcy; Financial distress; Capital structure; Supply chain

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