The Regressive Effects of Worker Protection: The Role of Financial Constraints

Diego Huerta *

January 27, 2025

[Latest version]

Abstract

I exploit the staggered adoption of U.S. state-level employment protection legislation (EPL) to study its effects on labor earnings and firms' profits. I find that EPL has unintended regressive consequences. EPL harms smaller firms and their workers, while only benefiting larger firms and their workers. The effects on smaller firms are driven by EPL limiting access to credit and raising debt costs, forcing them to reduce investment and employment. Conversely, larger firms expand their operations due to a decrease in their cost of debt. A model with heterogeneous firms and endogenous financial constraints guides the empirical analysis.

Keywords: EPL, labor earnings, firm profits, financial constraints.
JEL: G32, J63, K31

*Department of Economics, University of Chile, Diagonal Paraguay 257, Santiago, Chile.
Email: dhuertad@fen.uchile.cl. Web: diegohuertad.com.
I thank Georgy Egorov, Nicola Persico, Giorgio Primiceri, Alejandro Micco, Eduardo Engel, Rudi Bachman, Pablo Muñoz, Effi Benmelech, Paola Sapienza, Benjamin Chabot, Tomás Rau, Jorge Rodríguez, Jana Obradovic, Pablo Sanchez, Pablo Gutiérrez, Sebastian Sardon and Nicolás Garrido for very useful comments and discussions, as well as seminar participants at Northwestern University, and University of Chile. I thank the Center for International Macroeconomics (CIM) from Northwestern University for providing financial assistance.

1 Introduction

The inherent asymmetric relationship between employers and employees forms the foundation for the existence of labor regulations (Botero et al., 2004). In particular, Employment Protection Legislation (EPL) aims to shield workers from unfair dismissal by imposing termination requirements, including severance payments, notice periods, and reinstatement. However, the intended benefits of EPL may not materialize if firms struggle to adapt to the higher labor costs. In such cases, firms may resort to cost-cutting measures like reducing hiring or lowering wages (Autor et al., 2006, 2007), ultimately harming workers.

The ability of firms to absorb unanticipated shocks, such as increased labor costs, is often constrained by their access to credit (Benmelech et al., 2019; Mehrotra and Sergeyev, 2021). Thus, the extent to which workers benefit from EPL may be limited by their firms' financial constraints. On the firm side, those with better access to credit may benefit from EPL if their financially constrained competitors struggle to absorb higher labor costs. This raises the questions: Does labor protection benefit all workers? Does it harm all firms?

There is renewed interest in the distributional effects of labor regulations. A growing literature shows that minimum wages reduce wage and earnings inequality (Cengiz et al., 2019; Derenoncourt and Montialoux, 2021; Engbom and Moser, 2022; Dustmann et al., 2022). Similarly, unions decrease income inequality (Knepper, 2020; Farber et al., 2021; Dodini et al., 2023) but hurt smaller firms (Dodini et al., 2024). A third strand explores the effects of partial EPL reforms. Relaxed EPL for temporary workers benefits firms and widens the age wage gap (Daruich et al., 2023), while extending EPL to temporary agency workers harms firms (Micco and Muñoz, 2024).

Although the financial literature documents that EPL distorts firms' decisions by constraining access to external capital (Simintzi et al., 2015; Serfling, 2016; Caggese et al., 2019; Bai et al., 2020), the role of financial constraints in shaping the effectiveness of EPL remains largely unexplored. This paper addresses this gap from a theoretical and an empirical perspective. The main finding is that the EPL-finance interaction leads to unintended regressive consequences: EPL reduces profits and labor earnings in smaller firms while benefiting larger firms and their workers.

To guide the empirical analysis, I first build a model in which agents differ by their wealth (assets) and choose whether to become workers or to invest in a firm and become entrepreneurs. Investment decisions are constrained by endogenous credit limits that depend positively on assets but negatively on the strength of EPL. The model captures well-documented empirical findings from the labor-finance literature: EPL crowds out external finance (Serfling, 2016), discouraging investment (Bai et al., 2020), decreasing employment (Autor et al., 2006, 2007), and increasing debt costs (Alimov, 2015).

The model delivers two novel testable hypotheses. First, strengthening EPL reduces profits and labor earnings in smaller firms while benefiting larger firms and their workers. Second, the effects on smaller firms are driven by EPL limiting credit access and raising debt costs, forcing them to cut investment and employment. Perhaps surprisingly, larger firms expand operations due to a decrease in their debt costs driven by reduced credit demand from smaller firms.

To test the model's predictions, I exploit the staggered adoption of the *good faith exception* to "at-will employment" by U.S. states from 1967 to 1995. Historically, at-will employment allowed employers to terminate employees without prior notice or legal liability. From the 1960s to 1990s, several state courts adopted common law exceptions to at-will employment, known as Wrongful Discharge Laws (WDLs). WDLs aimed to ensure fairness and justice by providing employees with job security and a legal recourse against unjust terminations (Walsh and Schwarz, 1995). Among WDLs, the *good faith exception* is the largest deviation from at-will employment because termination must be for just cause (Dertouzos and Karoly, 1992; Kugler and Saint-Paul, 2004).

Overall, the *good faith exception* effectively strengthened EPL and raised firing costs due to a rise in wrongful termination lawsuits (Jung, 1997; Boxold, 2008). In this paper, I rely on the staggered enactment of the *good faith exception* to identify the causal effect of improved EPL on labor and firm earnings.[1] I implement a triple-differences research design for Compustat firms. The treated and control groups consist of firms with different sizes headquartered in states that have and have not passed the *good faith exception*.

The empirical analysis supports the model's first hypothesis that EPL has unintended regressive consequences. Following the *good faith exception* adoption, labor earnings fall by 35% relative to the mean at firms at the 25th percentile of assets and increase by 1% at the 75th percentile. Firms earnings decline by 27% for firms at the 25th percentile of size and rise by 4% at the 75th percentile. All these magnitudes are statistically significant. These results remain robust when controlling for the traditional firm-level characteristics from the labor-finance literature (e.g., Serfling, 2016) and state-level economic and political factors. Alternatively, I include state-year fixed effects to account for any state-year omitted variables.

To test the model's theoretical mechanism, I employ four financial constraints measures used in related studies (e.g., Ellul and Pagano, 2019; Bai et al., 2020): the Hadlock and Pierce (2010), Kaplan and Zingales (1997), Whited and Wu (2006) indices, and an indicator for non-dividend payers. I examine the impact of the *good faith exception* on labor and firm earnings, employment, investment, debt, and debt costs, conditional on pre-regulatory financial constraints. As predicted

[1] The *good faith exception*, along with the public policy and the implied contract exceptions, constitute the Wrongful Discharge Laws (WDLs) enacted by U.S. states as deviations from the at-will employment principle (see Section 4). The adoption of WDLs has been extensively used in the literature to identify the impact of enhancing worker protection on the real economy and various firm-level decisions. See, for instance, Dertouzos and Karoly (1992, 1993); Autor (2003); Autor et al. (2004, 2006, 2007); Acharya et al. (2014); Serfling (2016); Bai et al. (2020); Fairhurst et al. (2020); Dang et al. (2021); Bena et al. (2022); Johnson et al. (2024).

by the model, a group of financially constrained firms—those above the 75th percentile of financial constraints—reduce their earnings, employment, investment and debt after the law's passage, while facing higher debt costs. This suggests that the decline in labor and firm earnings for smaller firms is driven by EPL limiting credit access and raising debt costs, forcing them to cut investment and employment. Conversely, less financially constrained firms—those below the 25th percentile of financial constraints—expand their operations due to lower debt costs.

The crucial assumption for a causal interpretation of these results is that, in the absence of EPL adoption, the change in labor and firm earnings across firms with different sizes would have been the same for both treated and non-treated firms. Many features of WDLs identified in the literature and several robustness tests suggest that this common-trend assumption holds.

A first concern is whether "at-will employment" enables smaller, financially constrained firms to mitigate profit declines by dismissing workers, thereby reducing labor earnings. If so, courts may adopt EPL to protect workers from unfair dismissal. However, WDLs adoption stems from legal merits rooted in common law, rather than political or economic factors (Walsh and Schwarz, 1995; Autor, 2003). To test for possible pre-existing trends, I follow Bertrand and Mullainathan (2003) by exploring the timing of changes in labor and firm earnings relative to *good faith exception* across firms of different sizes. I find that earnings decline more in smaller firms only after EPL enactment, suggesting that the main results do not suffer from reverse causality.

Second, the *good faith exception* adoption and the dependent variables may spuriously correlate with fundamental economic and political forces. Thus, I control for additional factors identified as possibly affecting WDLs adoption (Serfling, 2016). These include political leaning, unionization rates, the adoption of other state-level labor laws, and the *good faith exception* adoption within the same federal circuit (Bird and Smythe, 2008).

Third, the gradual and staggered adoption of EPL means firms can be in both the treated and control groups, alleviating concerns about large differences between both groups. To further address these concerns, I show that the results are robust to propensity score matching based on a large set of firm characteristics. Additionally, since Compustat provides only the latest headquarters locations, I account for relocation by supplementing it with data on historical headquarters. Overall, the main empirical findings are robust to various econometric concerns.

Finally, an important limitation of Compustat is that only 12% of firms report labor earnings, raising concerns about sample bias. To address this, I employ two approaches, which increase the number of firms with labor earnings data to 71% and 61%, respectively. First, I construct an alternative labor expense measure by supplementing Compustat with historical annual payroll data from the County Business Patterns (CBP), categorized by state, four-digit industry code, and firm size. Second, I employ a matched wage and benefits imputation method based on firm characteristics, state, and three-digit industry code. Both approaches confirm that EPL reduces labor earnings in smaller firms but it increases them in larger firms.

This paper contributes to four strands of literature. The first strand examines how EPL affects various corporate decisions such as leverage, investment, and innovation through a financial channel (Simintzi et al., 2015; Serfling, 2016; Alimov, 2015; Caggese et al., 2019; Bai et al., 2020; Acharya et al., 2014; Griffith and Macartney, 2014; Bena et al., 2022; Dang et al., 2021; Fairhurst et al., 2020; Li et al., 2023; Cui et al., 2018; Karpuz et al., 2020; Beuselinck et al., 2021).[2] Many of these papers exploit the adoption of WDLs.[3]

Second, a growing literature examines the redistributive effects of different labor regulations, such as minimum wages (Derenoncourt and Montialoux, 2021; Engbom and Moser, 2022; Dustmann et al., 2022; Vergara, 2023; Berger et al., 2024), unions (Knepper, 2020; Farber et al., 2021; Dodini et al., 2023, 2024) and partial EPL reforms (e.g., Daruich et al., 2023; Micco and Muñoz, 2024). This article contributes to these first two strands by showing that the interplay between financial constraints and EPL is a key channel determining the effectiveness of EPL and inducing size-contingent distortions. The EPL-finance interaction emerges as a promising avenue for future research on the misallocation effects of EPL.

Third, this paper adds to the political economy literature on labor policies. Botero et al. (2004) argue that labor regulations respond to economic interest groups. Papers that formalize this idea include Pagano and Volpin (2005), Perotti and von Thadden (2006), and Fischer and Huerta (2021). This article contributes to this literature by providing empirical evidence for the existence of such interest groups, as EPL has differential effects across groups of workers and firms.

Finally, this paper provides empirical support for the widespread use of size-contingent EPL, which applies softer regulations to smaller firms. This policy has received significant attention in the quantitative macro literature (Gourio and Roys, 2014; Garicano et al., 2016; Aghion et al., 2023) and political economy literature (Boeri and Jimeno, 2005; Huerta, 2024). The firm-dependent distortions that originate from financial frictions represent a fruitful area for future research on the determinants and distributional effects of various size-contingent regulations. Examples include special tax treatments, subsidized credit, and restrictions on business expansion.

The paper is organized as follows. Section 2 presents the model. Section 3 derives the testable predictions. Section 4 outlines WDLs' institutional background. Section 5 describes the data and empirical methodology. Section 6 shows the empirical findings. Section 7 tests the mechanisms. Section 8 discusses econometric concerns and reports robustness tests. Section 9 concludes.

[2]This article also relates to the literature on the impact of financial constraints on firms' employment. See, for instance, Pagano and Pica (2012); Chodorow-Reich (2014); Duygan-Bump et al. (2015); Benmelech et al. (2021); Mehrotra and Sergeyev (2021); Fonseca and Van Doornik (2022).

[3]Papers exploring the impact of WDLs on various labor market outcomes include Dertouzos et al. (1988); Dertouzos and Karoly (1992); Miles (2000); Autor (2003); Autor et al. (2006); Johnson et al. (2024). Papers studying the impact of other types of labor regulations on firms' corporate decisions include Agrawal and Matsa (2013); Chava et al. (2020); Ellul and Pagano (2019); Jeffers (2024).

2 The Model

This section describes the model. I build on the setting developed by Fischer and Huerta (2021), which incorporates endogenous financial constraints, occupational choice, and firms' heterogeneity in labor and capital in a tractable way.

My model incorporates three key features relative to Fischer and Huerta (2021), leading to novel predictions for the effects of EPL across groups of workers and firms. First, it distinguishes between individual and collective dismissal regulations (EPL). Second, the wage and interest rate are jointly determined in equilibrium, depending on EPL strength and the wealth distribution. Third, wage rigidities prevent the equilibrium wage from fully adjusting to changes in EPL. These rigidities, such as minimum wages and collective bargaining, are particularly relevant at the state level in the U.S. (De Ridder and Pfajfar, 2017). They influence the extent to which wage adjustments can mitigate the economic impact of EPL.

Citizens are heterogeneous in wealth (assets) and are endowed with one unit of labor. The probability density function of wealth $g(a)$ is continuously differentiable, has support in $[0, a^M]$ and mean $A > 0$. Agents decide either to be workers or entrepreneurs. An entrepreneur who invests k units of capital and hires l units of labor produces $f(k, l) = k^\alpha l^\beta$, with $\alpha + \beta < 1$. Agents are price takers in both the capital and labor markets. The endogenous price of capital and labor are denoted by ρ and w, respectively. The price of the single good is normalized to one.

2.1 Timeline

The single period is divided into three stages (see Figure 1). In what follows, I describe the events that take place at each stage.

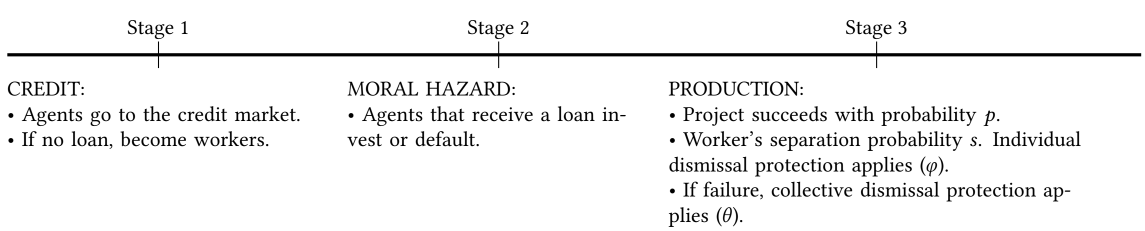


Figure 1: Timing.

2.1.1 Stage 1: Credit

A competitive banking system provides credit to potential entrepreneurs through deposits, with the equilibrium interest rate ρ clearing capital supply and demand (see equation (2.10)). Due to credit market imperfections, banks restrict credit in three ways: by setting a minimum collateral for a loan ($\underline{a}$), by defining asset-based debt limits ($d(a)$), and by charging differentiated interest rates ($r(a)$). Section A.1 in the Appendix details these credit constraints. Excluded agents become workers ($a < \underline{a}$), while the rest can obtain credit to invest in a firm ($a \geq \underline{a}$).

2.1.2 Stage 2: Moral Hazard

Banks provide credit to entrepreneurs facing a moral hazard problem: investment decisions are not contractible, and banks are imperfectly protected against default. Agents receiving a loan ($a \geq \underline{a}$) can either honor the credit contract and invest in a firm, or default to finance private consumption. In the latter case, the legal system recovers only a fraction $1 - \phi$ of the capital, where $1 - \phi$ represents the loan recovery rate or the strength of creditor rights.[4]

2.1.3 Stage 3: Production

In the last stage, firms succeed with probability $p \in (0, 1)$. In that case, they produce $f(k, (1-s)l)$, where $k = a + d$ is the capital invested by an entrepreneur with wealth a who asks for a loan d. Entrepreneurs use their own labor to manage the firm, and thus must hire labor l from workers for production. There is an exogenous job separation probability, $s \in [0, 1]$. Therefore, $(1 - s)l$ is the "effective" labor used for production of a firm that hires l units of labor. When a worker is fired, with probability s, entrepreneurs must pay her a fraction φ of her labor income wl. Hence, φ represents the strength of individual dismissal protection.

With probability $1 - p$, production fails and the firm initiates a collective dismissal for economic reasons. The legal system can only recover a fraction η of total invested capital k. The recovered capital is distributed among creditors, i.e. between banks and workers. First, a fraction θ of labor income is paid to workers. Then, the rest $\eta k - \theta wl$, goes to banks. Hence, θ can be interpreted as the strictness of collective dismissal protection.

In sum, workers face two risks: individual separation or collective layoff for economic reasons. EPL protects them against both risks, with the pair (φ, θ) representing the strictness of individual and collective regulations, respectively.

2.2 Payoffs

The expected profits of a bank from lending d at the interest rate r to an entrepreneur with assets a, who hires l units of labor, are:

$$\Pi^B = p(1 + r)d + (1 - p)(\eta k - \theta wl) - (1 + \rho)d. \tag{2.1}$$

[4] Fischer et al. (2019) develop a model with a similar financial structure where the amount recovered by the legal system is a general function of ϕ and debt. The qualitative predictions of the model would not change under this more general specification.

Firm profits of such entrepreneur are given by:

$$\Pi^E = p[f(k, (1-s)l) - (1-s)wl - s\varphi wl - (1+r)d], \tag{2.2}$$

while the total labor earnings in that firm are:

$$\Pi^W = p[(1-s)wl + s\varphi wl] + (1-p)\theta wl = \bar{w} \cdot l, \tag{2.3}$$

where $\bar{w} \equiv (p[(1-s)+s\varphi] + (1-p)\theta) \cdot w$ is the expected labor payment per unit of labor, referred to as *expected wage* for simplicity. Workers deposit their wealth, and thus obtain: $\Pi^W + (1+\rho)a$.

2.3 Equilibrium

This section describes the equilibrium given the strength of EPL, (φ, θ). In Sections 2.3.1 and 2.3.2, I describe banks' and entrepreneurs' decisions taking as given the factor prices w and ρ. In Section 2.3.3, I obtain the conditions that define these factor prices.

2.3.1 Banks' decisions

Imposing the zero profit condition, equation (2.1) gives the interest rate charged to an entrepreneur who borrows d, invests k, and hires l units of labor:

$$1 + r = \frac{1+\rho}{p} - \frac{1}{pd}(1-p)[\eta k - \theta wl]. \tag{2.4}$$

Banks charge differentiated interest rates, $r \equiv r(a)$, because in case of bankruptcy the loss that they incur depends on the share of investment and labor that is financed through debt.

2.3.2 Entrepreneurs' decisions

The entrepreneur's problem is:

$$\max_{d,l} \Pi^E$$

$$s.t. \;\; \Pi^E \geq \bar{w} + (1+\rho)a, \tag{2.5}$$

$$\Pi^E \geq \phi k, \tag{2.6}$$

where $k = a + d$, and (2.5) and (2.6) are the occupational and incentive compatibility constraints, respectively. Condition (2.5) asks that the agent prefers to form a firm instead of becoming a worker, while (2.6) states that the entrepreneur does not have incentives to default with the loan.[5] The unconstrained problem leads to the optimal size given by capital k^* and labor l^*:[6]

$$p f_k(k^*, (1-s)l^*) = 1 + r^*, \tag{2.7}$$

$$p(1-s) f_l(k^*, (1-s)l^*) = \bar{w}. \tag{2.8}$$

where $1 + r^* \equiv 1 + \rho - (1-p)\eta$. Note that (k^*, l^*) corresponds to the operation level that any agent will reach if loans were not limited by financial constraints. However, only sufficiently wealthy agents will attain the efficient operation scale.

In Section A.1 in the Appendix, I characterize the optimal debt contract. Two wealth thresholds define credit constraints on the extensive margin: a minimum wealth required for a loan ($\underline{a} > 0$), and a wealth cutoff ($\overline{a} > \underline{a}$) to obtain a loan to invest efficiently. Entrepreneurs with $a \in [\underline{a}, \overline{a})$ have restricted access to credit and operate at an inefficient scale. In this range, the marginal return to capital exceeds the cost of debt, so they request the maximum allowable loan.

To sum up, agents are endogenously classified into four groups, 1) those with $a < \underline{a}$ become workers and deposit their wealth, 2) financially constrained agents, $a \in [\underline{a}, \overline{a})$, who form inefficient firms, 3) those with $a \in [\overline{a}, k^*)$ who obtain an optimal loan and form an efficient firm, and 4) rich agents with $a > k^*$ who self-finance an optimal firm and deposit the rest of their wealth. Figure 2 summarizes these features. The supply of capital comes from agents in groups (1) and (4), while the demand for capital comes from entrepreneurs in groups (2) and (3).

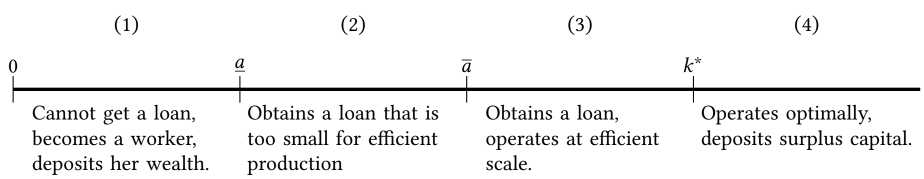


Figure 2: Agents' choices as a function of initial wealth.

2.3.3 Equilibrium prices

The labor market equilibrium wage w arises from:

$$G(\underline{a}) = \int_{\underline{a}}^{\overline{a}} l\, g(a) \partial a + l^*(1 - G(\overline{a})), \tag{2.9}$$

[5]Condition (2.6) implies that debt limits depend endogenously on firms' profits. This modeling approach aligns with the findings of Lian and Ma (2021) which indicate that firms' debt is predominantly cash-based in the US.

[6]Note that replacing equation (2.4) in (2.2) gives: $\Pi^E = pf(k, (1-s)l) + (1-p)\eta k - \bar{w}l - (1+\rho)d$. Differentiating in terms of k and l gives conditions (2.7) and (2.8).

where the left-hand side is total labor supply and the right-hand side is the labor demand. This condition uniquely defines the equilibrium wage w. The equilibrium interest rate ρ is defined by:

$$A = \int_{\underline{a}}^{\overline{a}} k \, g(a)\partial a + k^*(1 - G(\overline{a})), \tag{2.10}$$

where A is the aggregate capital in the economy which is given by the wealth distribution $g(\cdot)$, while the right-hand side is the demand for capital coming from firms.

3 Improving Employment Protection Legislation

In this section, I analyze the effects of strengthening EPL on workers' and firms' earnings. The experiment has three stages. Initially, the economy is subject to EPL (φ^0, θ^0), with initial interest rate ρ^0 and wage w^0. In the second stage, an unexpected labor reform increases φ or θ, or both. In the last stage, the economy operates under the new regulation. The interest rate fully adjusts to satisfy (2.10) yielding a new interest rate, ρ. However, wage rigidities prevent the wage from fully adjusting to EPL changes. In particular, the new wage is $w^i = w + i(w^0 - w)$, where w satisfies (2.9) under the new EPL, and i measures wage inflexibility.[7]

The parameter i captures wage rigidities present in many states in the U.S., such as minimum wages and collective bargaining, which prevent wages from fully adjusting to EPL changes (De Ridder and Pfajfar, 2017). Including wage rigidities in the model implies that EPL improvements generate unemployment (u). Thus, the labor market condition after EPL adoption becomes:

$$G(\underline{a}) + u = \int_{\underline{a}}^{\overline{a}} l \, g(a)\partial a + l^*(1 - G(\overline{a})), \tag{3.1}$$

which, given the new equilibrium wage w^i, determines unemployment u.

3.0.1 Effects on wages and the equilibrium interest rate

Lemma 1 *Consider a marginal increase in the strength of EPL, then the wage rate w^i goes down. If $i \in (0,1)$, then the* expected wage *$\bar{w}^i$ increases and the interest rate ρ decreases. If $i = 0$, then $\bar{w}^i$ and ρ remain unchanged.*

Lemma 1 shows that the equilibrium interest rate (ρ) and the wage rate (w^i) decrease when EPL improves. Despite this last effect, the *expected wage* $\bar{w}^i$ increases when there is some degree of wage inflexibility (i.e., $i \in (0,1)$). In what follows, I provide an intuition for these results.

[7] For a similar modeling approach to capture wage rigidities, see Garicano et al. (2016).

First, raising φ increases individual dismissal costs for entrepreneurs, which, *ceteris paribus*, heightens their incentives to behave maliciously. Second, higher θ reduces the capital recovered by banks in case of firm failure due to larger collective dismissal compensation. In both cases, banks tighten credit requirements for less capitalized firms by raising the minimum wealth to obtain credit $\underline{a}$, reducing debt limits $d(a)$, and raising debt costs $r(a)$. These predictions are consistent with empirical evidence showing that EPL reduces access to external finance (Simintzi et al., 2015; Serfling, 2016; Bai et al., 2020) and increases debt costs (Alimov, 2015).

From the perspective of labor markets, a higher $\underline{a}$ reduces the mass of entrepreneurs, thus raising the number of workers. Also, higher labor costs due to improved worker protection reduce firms' demand for labor. The combination of increased labor supply and decreased labor demand results in a lower equilibrium wage. In the credit market, the increase in the mass of workers raises total deposits, while loan demand declines, causing the interest rate ρ to go down.

The net impact of improved EPL on the *expected wage* $\bar{w}^i$ depends on two opposing effects: i) a decrease in the equilibrium wage w^i, but ii) an increase in labor payment in case of dismissal. Lemma 1 shows that effect ii) dominates in general (even when wage inflexibility is minimal). However, when wages are perfectly flexible ($i = 0$) both effects exactly counteract, and thus, $\bar{w}^i$ does not change in equilibrium (i.e. EPL is neutral).

3.1 Effects on firm profits

Proposition 1 *Consider a marginal improvement of EPL. Then, there are two critical wealth thresholds $a^L > \underline{a}$ and $a^H > a^L$ such that:*

1. *Π^E decreases for firms with $a \in [\underline{a}, a^L]$.*
2. *Π^E increases for firms with $a \in [a^H, \overline{a}]$.*

Proposition 1 describes the effect of improving EPL on firms' profits. Smaller firms ($a \in [\underline{a}, a^L]$) suffer from EPL while larger firms benefit ($a \in [a^H, \overline{a}]$). Improving the strength of EPL generates three effects: i) the *expected wage* ($\bar{w}^i$) increases, ii) the equilibrium interest rate (ρ) decreases, and iii) credit constraints become more binding for smaller firms, i.e. the minimum collateral ($\underline{a}$) and their cost of debt ($r(a)$) go up, while debt limits ($d(a)$) go down. Hence, the net effect of increased EPL on firms' profits depends on two opposing effects: I) higher labor costs and reduced access to credit for smaller firms, but II) a lower equilibrium interest rate.

In smaller firms, effect I) dominates. Stricter EPL tightens credit restrictions, forcing some firms to close. Those that survive must cut investment and hiring to continue operating, reducing output and profits.[8] Reduced investment lowers firms' profitability relative to debt. Thus, despite that the equilibrium interest rate ρ decreases, banks raise debt costs (r) for smaller firms.

In larger firms, effect II) dominates. After an EPL improvement, their credit capacity remains largely intact. Many employ unused debt capacity to adjust to higher labor costs and maintain an efficient scale. Also, stricter EPL lowers their debt costs, allowing them to expand investment and hiring. Thus, larger firms benefit from EPL, as reduced debt costs offset higher labor costs.

3.2 Effects on labor earnings

Proposition 2 *Consider a marginal improvement of EPL. Then, there are two critical wealth thresholds $\tilde{a}^L > \underline{a}$ and $\tilde{a}^H > \tilde{a}^L$ such that:*

1. Π^W *decreases for workers in firms with $a \in [\underline{a}, \tilde{a}^L]$.*

2. Π^W *increases for workers in firms with $a \in [\tilde{a}^H, \overline{a}]$.*

Proposition 2 predicts that strengthening EPL harms workers in smaller firms while benefiting only those in the large-scale sector. Two opposing effects determine this outcome: I) a higher *expected wage* ($\bar{w}^i$), but II) reduced employment.

Labor earnings decline in smaller firms ($a \in [\underline{a}, \tilde{a}^L]$) because effect II) dominates. EPL reduces their already limited access to credit, forcing them to substantially cut investment and hiring. As a result of the large decline in employment, labor earnings decrease in smaller firms. Conversely, EPL benefits workers in larger firms ($a \in [\tilde{a}^H, \overline{a}]$) because effect I) dominates. These firms can absorb EPL without significant reductions in hiring due to better access to credit. The largest firms can even expand employment due to lower debt costs, further increasing workers' earnings.

3.3 Main testable hypotheses

To sum up, the model leads to the following testable hypotheses:

Hypothesis 1:

i) *An improvement of EPL decreases labor earnings in smaller firms, while this effect is reversed in large firms.*

ii) *An improvement of EPL hurts smaller firms by decreasing profits. This negative effect is decreasing in size. Eventually, larger firms benefit from EPL.*

Hypothesis 2: *An improvement of EPL crowds out external finance and increases the cost of debt for smaller firms, forcing them to cut investment and employment. In contrast, large firms can increase investment and employment due to their easier access to credit and reduced cost of debt.*

[8] These predictions align with evidence showing that EPL reduces firm investment (Bai et al., 2020) and employment (Autor et al., 2006, 2007).

In Section 6, I test *Hypothesis 1* by exploring the effect of improving EPL on labor earnings and profits across firms with different assets. In Section 7, I test *Hypothesis 2*, which is the mechanism behind *Hypothesis 1*. Overall, the model predicts that the interaction between labor and financial frictions creates unintended regressive effects, as stricter EPL benefits larger firms at a high cost for the most vulnerable firms and workers.

4 Wrongful Discharge Laws

4.1 Institutional background

The "at-will employment" principle in the United States has historically allowed employers to terminate employees without prior notice or legal liability. This rule emerged from case law in the late nineteenth century and became the default for employment contracts by the early twentieth century (Morriss, 1994). Between the 1960s to 1990s, many states courts recognized one or more of three exceptions to the "at-will employment", known as Wrongful Discharge Laws (WDLs). WDLs aimed to ensure fairness and justice in employment by providing job security and a legal recourse against unjust terminations. The three exceptions are: i) the *implied contract exception*, ii) the *public policy exception*, and iii) the *good faith exception* (see Autor et al., 2004).

The implied contract exception protects workers from termination when the employer has implicitly promised not to discharge them without good cause. The public policy exception allows an employee to take legal action when termination contravenes some established public policy. The *good faith exception* is based on the contract law principle that employers should not take actions that would deprive employees of the benefit of the contractual relationship. Thus, termination cannot be out of bad faith, malice, or retaliation.

Of the three doctrines, the *good faith exception* is the largest deviation from "at-will employment", requiring termination to be for just cause (Dertouzos and Karoly, 1992; Kugler and Saint-Paul, 2004). Autor et al. (2007) show that the *good faith exception* adoption reduces employment volatility and entry, while the other exceptions may not have material effects on firms. Also, the *good faith exception* effectively strengthened EPL and raised firing costs due to a rise in wrongful termination lawsuits (Jung, 1997; Boxold, 2008). This law is the focus of this paper as it should create the largest impact on firms' decisions and outcomes.

4.2 Adoption of Wrongful Discharge Laws

To identify which court cases at each state set the precedent for adopting a WDL, I largely follow Autor et al. (2006). They search for the first major appellate-court decision indicating the sustained adoption of a given exception. Thus, a lower court decision adopting a WDL that was reversed on appeal is not counted, while a lower court or supreme court decision not reversed is counted as the law's enactment. Unlike Autor et al. (2006), I follow Walsh and Schwarz (1995) and code Utah as recognizing the *good faith exception* in 1989.

Table 1 reports the dates each state adopted each WDL. WDLs' adoption began in 1959 when California recognized the public policy exception. Most states adopted WDLs between the 1970s and 1990s. As indicated in parenthesis, some states later reversed their positions. New Hampshire in 1980 and Oklahoma in 1989 reversed the *good faith exception*, while Arizona in 1984 and Missouri in 1988 reversed the public policy exception. Figure 3 shows the number of states that adopted each exception between 1959 and 1998. In total, 43 states adopted the implied contract exception, 43 the public policy doctrine and 14 the *good faith exception*.

5 Sample Selection and Empirical Methodology

5.1 Sample selection

The sample includes U.S. Compustat firms from 1967 to 1995, covering five years before California's implied contract exception (1972) and five years after Ohio's public policy exception (1990). I largely follow Serfling (2016) for sample selection, resulting in 89,852 observations (compared to his 88,997). I exclude utilities (SIC 49000-4999), financial firms (SIC 6000-6999), and quasi-public firms (SIC>9900). Additionally, firms require two year of data to estimate firm fixed effects, and 3-digit SIC industries need at least two observations per year for industry-year fixed effects.

5.2 Measuring Labor Earnings

5.2.1 Compustat

The first source of labor earnings data comes from Compustat (item *XLR*). A limitation of Compustat is that only 11.6% of the firms disclose total labor earnings, resulting in 8,613 observations (the *restricted sample*). In Table 2, I report statistics for firms that disclose labor earnings and for those that do not (second and third columns). The average assets, sales, and employment of disclosing firms are about four to five times larger than those of non-disclosing firms.[9]

The bias toward larger firms may compromise identification, as these firms typically face fewer financial constraints and may adapt more easily to EPL. To examine heterogeneous effects of EPL on labor earnings, the restricted sample requires sufficient size variation among disclosing firms. Results in Section 6.1 suggest this condition is met: labor earnings in smaller firms

[9]The lack of data on labor earnings in Compustat is not new. Consistent with Table 2, Ballester et al. (2002) find that only 10% of firms report labor earnings. Moreover, they find that disclosing firms are disproportionately large and belong to more regulated industries.

decrease after the *good faith exception* adoption, while they increase in larger firms. Sample size is a constraint only for the labor earnings' analysis. To test Hypotheses 1.ii and 2, I make use of the full sample (Sections 6.2 and 7). To address potential sample selection bias, I construct two alternative labor earnings measures, as described in Sections 5.2.2 and 5.2.3.

5.2.2 CBP-supplemented data

First, I supplement Compustat with County Business Patterns (CBP) annual payroll data by state, four-digit industry code, and firm size from the National Archives. Labor expenses are calculated by multiplying CBP's average wages and benefits with Compustat firm-level employment. CBP data is balanced from 1974 onwards, which is the starting year for CBP-based labor expenses. Firms with available labor earnings data increase to 71%.[10]

5.2.3 Matching imputation

Second, I impute labor expenses by matching non-disclosing with similar disclosing firms based on firm characteristics, state, and three-digit industry code. Labor expenses are then calculated by multiplying matched wages and benefits by firm employment, increasing firms with available data to 61%. This approach is validated on firms that report labor expenses.

The last four columns of Table 2 report the statistics of firms with available and non-available data when labor earnings are constructed through CBP and matching imputation. The average size, sales, and employment of firms with available and non-available data are relatively close to those in the full sample (first column), which alleviate concerns about sample bias.

In sum, I use three proxies for labor earnings: i) item *XLR* in Compustat, ii) labor expenses calculated by multiplying CBP's annual wage and benefits (state, four-digit industry code, and firm size level) by firm employment (*CBP-supplemented*), and iii) imputed labor expenses for non-disclosing firms based on matching similar Compustat firms (*Matching imputation*).

5.3 Empirical methodology

I adopt a triple-differences strategy to examine the effect of the passage of the *good faith exception* on six variables across firms of different sizes and financial constraints. The dependent variables are: (i) labor earnings, (ii) firm earnings, (iii) employment, (iv) investment, (v) debt, and (vi) cost of debt. I estimate the following panel regression model:

[10] A similar approach to filling missing labor expenses data has been used in the literature (e.g., Bresnahan et al., 2002; Bloom and Van Reenen, 2007). Unreported regressions of Compustat labor earnings on CBP-supplemented labor expenses yield a coefficient of about 0.8, with an R^2 of 0.7. Both measures have similar means and standard deviations for Compustat-disclosing firms, validating the *CBP-supplemented* approach.

$$y_{i,s,t} = \alpha_0 + \alpha_1 \text{ Good faith}_{s,t} + \alpha_2 \text{ Good faith}_{s,t} \times \text{Z}_{i,s,t-1} + \alpha_3 \text{ Z}_{i,s,t-1} + \text{X}_{i,s,t-1}\beta + \nu_i + \delta_s + \eta_k \times \omega_t + \varepsilon_{i,s,t}, \tag{5.1}$$

where $y_{i,s,t}$ is one of the six variables i) to vi) for firm i in state s in year t. Good $\text{faith}_{s,t}$ is an indicator for whether the state in which the firm is headquartered has adopted the *good faith exception* as of year t. $\text{Z}_{i,s,t-1}$ corresponds to either firm size (assets) or a measure of financial constraints for firm i in state s at the beginning of the year.

When testing *Hypothesis 1* in Section 6, $\text{Z}_{i,s,t-1}$ represents the lagged log of assets (Log Assets_{t-1}). When testing *Hypothesis 2* in Section 7, $\text{Z}_{i,s,t-1}$ corresponds to one of four financial constraints proxies used in the labor-finance literature (e.g., Ellul and Pagano, 2019; Bai et al., 2020): i) the SA index (Hadlock and Pierce, 2010), ii) the KZ index (Kaplan and Zingales, 1997; Lamont et al., 2001), iii) the WW index Whited and Wu (2006), and iv) a non-dividend payer indicator.

The interaction term, Good $\text{faith}_{s,t} \times Z_{i,s,t-1}$, captures the impact of the *good faith exception* across firms with different assets or financial constraints. Based on equation (5.1), the effect of enhanced EPL (i.e., Good $\text{faith}_{s,t} = 1$) on $y_{i,s,t}$ at different assets and financial constraints can be calculated as follows:

$$(y_{i,s,t}|\text{Good faith}_{s,t} = 1) - (y_{i,s,t}|\text{Good faith}_{s,t} = 0) = \alpha_1 + \alpha_2 \times Z_{i,s,t-1}. \tag{5.2}$$

Consider the case in which $Z_{i,s,t-1}$ is firm assets. *Hypothesis 1* predicts $\alpha_1 < 0$ and $\alpha_2 > 0$. Thus, the effect of the *good faith exception* adoption on labor and firm earnings is negative for smaller firms. This negative effect weakens with firm size, and may become positive for larger firms. Now suppose that $Z_{i,s,t-1}$ measures financial constraints. *Hypothesis 2* predicts $\alpha_1 > 0$ and $\alpha_2 < 0$. Therefore, labor earnings, profits, investment, employment, and debt decrease for financially constrained firms, while this effect is weaker and potentially positive for less constrained firms. For the cost of debt, the sign of the coefficients are expected to reverse (i.e., $\alpha_1 < 0$ and $\alpha_2 > 0$).

5.3.1 Control variables

The regression model includes a set of control variables $X_{i,s,t-1}$ from the labor-finance literature (e.g., Bai et al., 2020; Serfling, 2016): log of the beginning-of-year book assets (Log Assets_{t-1}), lagged profitability ($\text{Profitability}_{t-1}$), lagged fixed assets ratio (Fixed assets_{t-1}), lagged market-to-book ratio (Market to book_{t-1}), dividend payer indicator (Dividend payer_t), lagged modified Altman's z-score (Modified z-score_{t-1}), and lagged book leverage (Book leverage_{t-1}).

For labor earnings regressions, I include alternative controls from Michaels et al. (2019) model of financing frictions and wage bargaining: log of sales (Log Sales_t), lagged log of capital expenditures (Capital expenditures$_{t-1}$), and lagged leverage (Book leverage$_{t-1}$). Table A1 and Table 3 provide variable definitions and summary statistics for both the restricted and full samples.

To attenuate omitted variable bias, all regressions include firm (ν_i), state (δ_s), and industry-year ($\eta_k \times \omega_t$) fixed effects. Standard errors are clustered at the state level. Since the *good faith exception* is adopted at the state level, this methodology accounts for residuals being serially correlated within a firm and across firms in the same state (Bertrand et al., 2004).

5.3.2 Addressing econometric concerns: summary

In what follows, I provide a summary of the most important econometric concerns. In Section 8, I present different robustness exercises that address these concerns.

Pre-treatment trends The crucial assumption for a causal interpretation is that, without the *good faith exception* adoption, the change in labor and firm earnings across firms with different sizes would have been the same for both treated and control firms. In Section 8.1, I follow Bertrand and Mullainathan (2003) and explore the timing of changes in labor and firm earnings relative to the *good faith exception*. The results show that earnings decline more in smaller firms only after the *good faith exception* adoption, supporting the parallel trend assumption.

States' local economic conditions To account for local economic conditions, I control for lagged state-level log of GDP per capita (Log State per capita GDP$_{t-1}$) and lagged state GDP growth (State GDP growth$_{t-1}$). Alternatively, I include state-year fixed effects to account for time-varying omitted variables affecting all firms in the same state each year. In particular, as discussed in Section 2, state-level differences in wage rigidities over time influence the responsiveness of wages to EPL, and thus, the impact of EPL on labor and firm earnings.

Adoption in neighboring states Another concern is whether precedents from neighboring states influenced WDLs adoption. While Walsh and Schwarz (1995) find that state precedents influenced the adoption of the implied contract and public policy exceptions, this is not the case for the *good faith exception*. Bird and Smythe (2008) show that federal circuit precedents were more influential than neighboring states. To address this, I control for the fraction of states in the same federal circuit that had passed the *good faith exception* in the previous year (Circuit good faith$_{t-1}$).

Political conditions Although WDLs adoption might have been influenced by state politics or lobbying, their common law roots suggest recognition was driven by merits rather than political considerations (Autor, 2003). In Section 8.2, I address residual concerns by controlling for three state-level variables that may have shaped the *good faith exception* adoption (Serfling, 2016): i) the fraction of state's Democrats in the U.S. Congress (Political balance$_t$), ii) right-to-work laws (Right-to-work$_t$), and iii) collective bargaining coverage (Union membership$_t$). The latter two also potentially capture differences in state-level wage rigidities.

Headquarters locations EPL applies to the state where a firm is located. However, Compustat provides only the latest headquarters location. To account for relocations, in Section 8.3, I supplement Compustat with historical headquarters data.

Differences in treated and control groups Table 4 compares the sample means of firms in states adopting the *good faith exception* (treatment firms) with those in non-adopting states (control firms). The table presents statistics for both the restricted and full samples. While the full sample shows significant differences between the treatment and control firms, the restricted sample reveals more similarity for EBIT$_t$, EBITDA$_t$, Capital expenditures$_t$, and Assets$_{t-1}$. The gradual and staggered adoption of EPL implies that firms can be in both the treatment and control groups over time, alleviating to some extent concerns about treated and non-treated firms differences. To address this issue more directly, In Section 8.4, I employ a propensity score matching procedure.

6 Empirical Results

6.1 Employment protection and labor earnings

In this section, I test item i) of *Hypothesis 1* by examining the impact of the *good faith exception* on labor earnings. The Hypothesis predicts that EPL reduces labor earnings in smaller firms, with this negative effect diminishing as firm size increase. Eventually, EPL increases labor earnings in larger firms, effectively benefiting their workers through higher protection.

6.1.1 Average change of labor earnings

I begin with a graphical analysis of the *good faith exception* adoption and labor earnings. Panel a) of Figure 4 shows the effect of the *good faith exception* on Compustat labor earnings in treated versus control firms. Labor earnings are normalized by their sample mean. Thus, coefficients changes reflect percentage change relative to the mean (in decimal form). Following Autor et al. (2006) and Acharya et al. (2014), I regress labor earnings on adoption-year indicators with year fixed effects. The plot shows the coefficients for ±5 years around the adoption, with 90% (dashed lines) confidence intervals using standard errors clustered by state.

Prior to the *good faith exception*, labor earnings of treated and control firms are not statistically different. In the years after the adoption, labor earnings are on average lower for treated firms, suggesting similar pre-treatment trends. Importantly, the graph does not consider the differential effects across firms of different sizes. In Section 8.1, I conduct a formal test for the parallel trend assumption that, without treatment, the change in labor earnings and profits across firms of different sizes would have been the same for treated and control firms.

6.1.2 Testing Hypothesis 1: change in labor earnings by firm size

I examine the effect of the *good faith exception* on labor earnings by firm size using $Z_{i,s,t-1} = \text{Log Assets}_{i,s,t-1}$ in equation (5.1). Table 5 shows the results using Compustat labor earnings normalized by the sample mean, with coefficients reflecting percentage changes in decimal form. All regressions include WDL exceptions indicators, firm, state, and industry-year fixed effects, plus the interaction term, Good faith$_t$ × Log Assets$_{t-1}$, which is the main interest coefficient.[11] Consistent with *Hypothesis 1*, the interaction term is positive, while Good faith$_t$ is negative. Both coefficients are statistically significant. Thus, EPL reduces labor earnings in smaller firms, with the effect decreasing as assets increase.

Column (4) is the primary model specification with firm and state-level controls. Columns (2) to (4) use the control variables from Serfling (2016), while columns (5) to (7) use controls from Michaels et al. (2019). Columns (4) and (7) include state-level controls, whereas columns (3) and (6) include state-year fixed effects to account for time-varying state-level omitted factors. The state-year fixed effects do not fully absorb Good faith$_t$ due to a misalignment between month-ends and fiscal year ends. Including state-level variables or state-year fixed effects generally strengthens the statistical significance of the interaction term.

The interpretation of the results is as follows. For instance, consider a firm that has average assets, Log Assets$_{t-1}$ = 4.74. Based on column (4) of Table 5, the effect of the *good faith exception* adoption on labor earnings is: $-0.726 + 0.120 \times 4.74 = -0.16$ (see equation (5.2)). Thus, in a firm with average assets, the passage of the *good faith exception* reduces labor earnings by 16%. In Table 6, I repeat the regressions from Table 5 but using the constructed proxies for labor earnings: *CBP-supplemented* and *Matching Imputation* (see Section 5.2). The results under all specifications remain qualitatively similar to those of Table 5.

To illustrate *Hypothesis 1*, Panel a) of Figure 5 shows the marginal effect of the *good faith exception* adoption (Good faith$_t$ = 1) on labor earnings conditional on Log Assets$_{t-1}$. Calculations are based on column (4) of Table 5. The graph remains qualitatively similar when using the estimated coefficients of column (7) or those of Table 6. The black solid line is the marginal effect of Good faith$_t$ on labor earnings according to expression (5.2). Dashed lines are the 90% confidence intervals. Black dots indicate assets percentiles.

[11] All regressions in the paper also include interactions of other WDLs with assets or financial constraints to account for possible heterogeneous effects of other WDLs. These coefficients are not reported for space considerations.

The *good faith exception* reduces labor earnings by 35% ($430 million) and 17% ($209 million) for a firm in the 25th and 50th percentile of assets, respectively. On the other hand, the exception raises labor earnings by 1% ($12 million) in a firm at the 75th percentile. The data supports the model's prediction that there is a size threshold below which labor earnings decrease with EPL. Panel a) of Figure 5 indicates that this threshold is around Log assets$_{t-1}$ = 5.8 ($330 million).

6.2 Employment protection and firm earnings

In this section, I study the impact of the *good faith exception* on EBIT (and EBITDA) to test item ii) of *Hypothesis 1*: EPL reduces profits of smaller firms, while it increases profits of larger firms.

6.2.1 Average change of firm earnings

Panel b) of Figure 4 shows the effect of the *good faith exception* on EBIT. The results are similar for EBITDA. Before the *good faith exception*, EBIT of treated and control firms is not statistically different. EBIT is on average lower for treated firms only after the law's passage, supporting the parallel trend assumption. In Section 8.1, I test that, without treatment, the change in profits across firms with different sizes would have been the same for treated and control firms.

6.2.2 Testing Hypothesis 1: change in firm earnings

Table 7 shows the results from estimating equation (5.1) by using EBIT or EBITDA as the dependent variables. As before, I normalize these measures by their sample means. Columns (1)-(6) consider the full sample, while columns (7)-(10) use the restricted sample. Firm-level controls are those from Serfling (2016). Columns (4) and (6) are the primary specifications, which include state-level controls. Alternatively, columns (3), (5), (7) and (9) use state-year fixed effects to account for unobserved time-varying state-level factors. Standard errors are clustered by state.

Consistent with the model, the coefficient for the interaction term, Good faith$_t$ ×Log Assets$_{t-1}$, is positive and significant at least at the 90% level across all specifications and for both samples, whether using EBIT or EBITDA. The coefficient for Good faith$_t$ is negative and statistically significant at the 90% level in almost all specifications. Thus, the data supports item ii) of *Hypothesis 1*: EPL reduces profits of smaller firms, and this negative effect decreases with size.

Using expression (5.2) and the coefficients of column (4), the marginal effect of Good faith$_t$ on EBIT for a firm with average assets (Log Assets$_{t-1}$ = 4.74) is: $-0.756 + 0.170 \times 4.74 = 0.05$. Similarly, for EBITDA, this value is 0.048. Thus, for a firm with average assets, the *good faith exception* increases firm earnings by 5% ($8 millions).

Panel b) of Figure 5 shows the marginal effect of Good faith$_t$ on EBIT conditional on firm assets. The *good faith exception* reduces EBIT by 27% ($40 million) for a firm in the 25th percentile of assets. For a firm in the 50th and 75th percentiles, the good faith increases EBIT by 4% ($6 million) and 35% ($52 million), respectively. The data supports the model's prediction that there is a size threshold above which firm profits increase with improved worker protection. Panel b) of Figure 5 indicates that this threshold is around Log assets$_{t-1}$ = 4.4, i.e., $85 million in assets.

7 Testing Mechanisms

Section 6 presents evidence for *Hypothesis 1*: EPL reduces labor earnings and profits of smaller firms while benefiting larger firms and their workers. In this section, I test *Hypothesis 2*: EPL limits credit access and raises debt costs for smaller firms, forcing them to cut investment and employment. Employment drops enough to offset increased dismissal compensation, reducing labor earnings. Larger firms benefit from lower debt costs, expanding operations and profits. Labor earnings in larger firms rise due to higher protection and expanded employment.

To test *Hypothesis 2*, I first estimate the impact of the *good faith exception* on labor and firm earnings, conditioned on four financial constraints proxies (Section 7.1). I then examine its impact on employment, investment, debt, and debt costs at different financial constraints (Section 7.2).

7.1 Financial constraints and earnings

Labor earnings Table 8 presents the results using labor earnings as dependent variable, with $Z_{i,s,t-1}$ in equation (5.1) representing one of four proxies for financial constraints. Columns (1)-(2) and (9)-(10) use the SA index, columns (3)-(4) the KZ index, columns (5)-(6) the WW index, and (7)-(8) define non-dividend payers as constrained firms. A higher value of any measure indicates stricter financial constraints. The signs of the interest coefficients are expected to reverse compared to Section 6, i.e., $\alpha_1 > 0$ and $\alpha_2 < 0$.[12] Thus, the *good faith exception* should reduce labor earnings and profits in firms that were more financially constrained before the law's adoption.

The upper table in Table 8 uses firm-level controls from Serfling (2016), the bottom table uses controls from Michaels et al. (2019). Odd columns include state-year fixed effects, while even columns use state controls. As predicted by the model, the interaction term is significant and negative when using the SA index or non-dividend payers to proxy financial constraints. With Michaels et al. (2019) controls, the interaction term remains negative and significant for the WW index. The results are robust for *CBP-supplemented* labor earnings, which span a larger set of firms comparable in assets, sales, and employment to the full Compustat (see Table 2).

[12] The SA index is negative for the least financially constrained firms. Therefore, α_1 is expected to be negative when using this measure. This is confirmed by the results presented in columns (1)-(2) and (9)-(10) from Table 8 and columns (1)-(2) from Table 9.

The results in Table 8 support the model's prediction that stronger EPL reduces labor earnings in more financially constrained firms. Columns (3) and (4) show no effect with KZ index, consistent with Hadlock and Pierce (2010), who question its validity.

Firm earnings Table 9 repeats the analysis using EBIT (upper table) and EBITDA (bottom table) as dependent variables. As predicted, the interaction term is negative and significant when using the SA index or the non-dividend payer indicator as financial constraints proxies. The interaction with the WW index is also negative and significant for EBITDA. The evidence suggests that EPL reduces firm earnings in firms that were more financially constrained before EPL adoption.

7.2 Financial constraints, employment, investment, debt and the cost of debt

In this section, I test *Hypothesis 2* more directly. I investigate whether the decrease in labor and firm earnings in smaller firms after the *good faith exception* adoption is due to EPL limiting credit access and raising debt costs, forcing them to reduce investment and hiring. If true, the decrease in investment and employment should be more pronounced in smaller, more financially constrained firms. I also explore whether the increase in profits in larger firms results from expanded investment and employment due to reduced debt costs.

I estimate specification (5.1) using four dependent variables: i) item *EMP* for employment, ii) *CAPX* (capital expenditures) for investment, iii) item *DLC* (debt in current liabilities) plus *DLTT* (long-term debt) for total debt[13], and iv) item *XINT* (total interest expenses) over total debt for debt costs. $Z_{i,s,t-1}$ is either lagged log of assets or a financial constraints proxy. The interaction term, Good Faith$_{s,t} \times Z_{i,s,t-1}$, should be positive for assets and negative for financial constraints, with opposite signs for debt costs. Tables 10 and 11 show the results using firm controls from Serfling (2016). Odd columns include state-year fixed effects, even columns use state controls.

The findings support *Hypothesis 2*. The SA index interaction is significant with the expected sign across all specifications. For investment, it is also significant when using log of assets or non-dividend payers to proxy financial constraints. For debt, it is significant and has the correct sign for the WW index or the non-divided payer indicator. For debt costs, it is significant and has the predicted sign when using log of assets, the KZ index, or the non-dividend payer indicator. This evidence suggests that stronger worker protection reduces investment and employment by crowding out access to capital, particularly for smaller, more financially constrained firms.

Figure 6 shows the marginal effect of the Good faith$_t$ on employment, investment, debt, and debt costs conditional on the SA index. Higher values of the index mean stricter financial constraints. As predicted by the model, there is a range of financially constrained firms—with an SA

[13]Unreported regressions show that the results are robust to using debt net of cash holdings. This accounts for firms raising liquid assets when labor costs increase.

index above the 75th percentile—that cut investment and employment after the *good faith exception* adoption. There is a second group of less financially constrained firms—with an SA index below the 25th percentile—that expand their operations due to decreased debt costs.

8 Econometric Concerns

8.1 Pre-treatment trends

Figure 4 reveals similar pre-treatment trends for treated and control firms. A key concern is whether "at-will employment" allows firms—especially smaller, financially constrained ones—to offset profit declines by dismissing workers, thus reducing labor earnings. If so, courts may pass the *good faith exception* to prevent unfair dismissals. If reverse causality exists, smaller firms would show larger declines in profits and labor earnings before the *good faith exception* adoption.

To check for pre-existing trends, I adapt the approach of Bertrand and Mullainathan (2003) and examine changes in labor and firm earnings around the *good faith exception* across firms with different assets.[14] I replace Good faith$_t$ in specification (5.1) with: Good faith^{-1}, Good faith^{0}, Good faith^{+1} and Good faith^{+2}. These variables indicate if a state: i) will enact the exception in one year, ii) passes it in the current year, iii) adopted it one year ago, and iv) enacted it two or more years ago.[15] Their interaction with Log Assets$_{t-1}$ captures firm-specific pre-trends.

Table A2 shows that labor and firm earnings decline in smaller firms only post-*good faith exception* adoption. Using Compustat labor earnings (columns (1)-(4)), the interaction term is positive and significant at adoption but weakens later. For *CBP-supplemented* and *Matching Imputation* labor expenses (columns (5)-(8)), significance appears at adoption or two years after. Thus, greater worker protection reduces labor earnings in smaller firms only post-enactment.

Columns (9) to (12) use EBIT as dependent variable. For restricted sample (columns (9)-(10)), the *good faith exception* reduces profits of smaller firms only one year later. For the full sample (columns (11)-(12)), the interaction term is slightly significant one year before the law's enactment. However, it is also more significant the year of EPL adoption and after two years.

Overall, Table A2 suggests that the main findings are not affected by reverse causality and that the parallel trend assumption holds. Labor earnings and profits decline relatively more in smaller firms only after the *good faith exception* adoption, validating the triple-differences strategy.

[14] To my knowledge, there is no standard method for testing parallel trends in triple-differences estimators with a continuous interaction variable. Although this estimator is widely used in empirical applications, its theoretical properties and testing the parallel trends remain active research topics in the econometrics literature (Olden and Møen, 2022; Strezhnev, 2023, 2024; Zhuang, 2024).

[15] Two states reversed the *good faith exception*: New Hampshire in 1980 and Oklahoma in 1989. I drop all observations for these states after the reversal.

8.2 Political conditions

WDLs stem from legal merits rooted in common law, so their adoption is unlikely driven by political factors or lobbying (Autor, 2003). Also, precedents from neighboring states affected the spread of the implied contract and public policy exceptions, but not the *good faith* (Walsh and Schwarz, 1995). To account for potential regional influences, all specifications control for the *good faith exception* adoption among states in the same federal circuit (Bird and Smythe, 2008).

To address residual omitted variable concerns, I include three state-level political variables potentially affecting the *good faith exception* adoption (Serfling, 2016): i) Political balance$_t$, fraction of Democrat representatives in Congress, ii) Right-to-work$_t$, indicator for right-to-work laws' passage, and iii) Union membership$_t$, fraction of employees with collective bargaining coverage. All specifications include the state-level economic factors from the main econometric model.

Table A3 shows the main findings are robust to political controls. Union membership and right-to-work laws are positively related to labor earnings. Both variables also potentially capture state-level wage rigidities that mediate EPL's effect on earnings through wages. Political factors show no significant impact on profits, employment, or investment.

8.3 Historical headquarters

EPL typically applies to the state where a firm is headquartered. A limitation of Compustat is that it only provides the latest locations. To account for relocation, I supplement Compustat with historical headquarters locations constructed by Bai et al. (2020).

Table A4 shows that the main findings are generally robust to using alternative data on headquarters location. The interaction term of Good faith$_t$ with assets and the SA index preserves the expected sign and remains significant for profits, employment, investment, debt and debt costs. The interaction term loses significance for Compustat labor earnings; likely due to a drop in the number of observations. In fact, when using imputed labor earnings, the interaction term becomes significant for log assets.

8.4 Matched sample

Table 4 shows that treated and control groups differ across several firm and state-level dimensions. To account for these differences, I have controlled for these factors in all regressions. To further address this concern, I employ propensity score matching based on log assets, profitability, fixed assets, market to book ratio, a dividend payers indicator, modified z-score, and book leverage. Each treated firm is matched to a control with replacement on year and three digit SIC industry. Table A5 presents the results, showing that the findings are robust to using a matched sample.

9 Conclusions

There is renewed interest in the distributional effects of labor regulations such as minimum wages, unions, and partial Employment Protection Legislation (EPL) reforms.[16] Although EPL distorts firms' decisions by reducing access to credit (Simintzi et al., 2015; Serfling, 2016; Bai et al., 2020), the role of financial constraints in shaping the effectiveness of EPL remains largely unexplored. This paper addresses this gap by showing that the EPL-finance interaction creates unintended regressive consequences: EPL reduces profits and labor earnings in smaller firms while benefiting only larger firms and their workers.

To guide the empirical analysis, I first build a model where agents are heterogeneous in assets and choose to be either workers or entrepreneurs. Entrepreneurship is limited by endogenous credit limits that depend on assets and EPL. The model provides two testable predictions. First, EPL reduces profits and labor earnings in smaller firms while benefiting larger firms and their workers. Second, the negative effects on smaller firms are driven by EPL reducing access to credit and raising debt costs, forcing them to cut investment and employment. Larger firms expand their operations due to a decrease in their cost of debt induced by the decline in credit demand from smaller firms.

To test the model's predictions, I exploit the staggered adoption of the *good faith exception* by U.S. states to explore the impact of strengthened EPL on labor earnings, firm profits, investment, employment, debt and the cost of debt across firms with different sizes and financial constraints. I find empirical evidence that EPL creates regressive effects through its interaction with financial constraints.

This article points to several promising avenues for future research. First, the firm-dependent distortions from the interaction between EPL and financial constraints may induce misallocation effects, which could be further explored using employer-employee data. Second, the findings support the widespread implementation of size-contingent EPL, where smaller firms face softer regulations. The firm-dependent distortions coming from financial constraints provide a basis for future research on the emergence of other size-contingent policies, such as special tax treatments and credit subsidies. Finally, this paper underscores the importance of incorporating endogenous financial constraints that respond to policy changes in future work on optimal policy design.

[16] Recent studies on the distributional effects of minimum wages include Cengiz et al. (2019); Derenoncourt and Montialoux (2021); Engbom and Moser (2022); Dustmann et al. (2022). For unions, see Knepper (2020); Farber et al. (2021); Dodini et al. (2023, 2024). Articles focusing on partial EPL reforms include Daruich et al. (2023); Micco and Muñoz (2024).

References

Acharya, Viral V., Ramin P. Baghai, and Krishnamurthy V. Subramanian, "Wrongful Discharge Laws and Innovation," *The Review of Financial Studies*, 2014, *27* (1), 301–346.

Aghion, Philippe, Antonin Bergeaud, and John Van Reenen, "The Impact of Regulation on Innovation," *American Economic Review*, 2023, *113* (11), 2894–2936.

Agrawal, Ashwini K and David A Matsa, "Labor Unemployment Risk and Corporate Financing Decisions," *Journal of Financial Economics*, 2013, *108* (2), 449–470.

Alimov, Azizjon, "Labor Protection Laws and Bank Loan Contracting," *The Journal of Law and Economics*, 2015, *58* (1), 37–74.

Autor, David H, "Outsourcing at Will: The Contribution of Unjust Dismissal Doctrine to the Growth of Employment Outsourcing," *Journal of Labor Economics*, 2003, *21* (1), 1–42.

Autor, David H., John J. Donohue, and Stewart J. Schwab, "The Employment Consequences of Wrongful-Discharge Laws: Large, Small, or None at All?," *American Economic Review*, 2004, *94* (2), 440–446.

Autor, David H, John J Donohue III, and Stewart J Schwab, "The Costs of Wrongful-Discharge Laws," *The Review of Economics and Statistics*, 2006, *88* (2), 211–231.

__ , **William R Kerr, and Adriana D Kugler**, "Does Employment Protection Reduce Productivity? Evidence from US States," *The Economic Journal*, 2007, *117* (521), F189–F217.

Bai, John, Douglas Fairhurst, and Matthew Serfling, "Employment Protection, Investment, and Firm Growth," *The Review of Financial Studies*, 2020, *33* (2), 644–688.

Ballester, Marta, Joshua Livnat, and Nishi Sinha, "Labor Costs and Investments in Human Capital," *Journal of Accounting, Auditing & Finance*, 2002, *17* (4), 351–373.

Bena, Jan, Hernan Ortiz-Molina, and Elena Simintzi, "Shielding Firm Value: Employment Protection and Process Innovation," *Journal of Financial Economics*, 2022, *146* (2), 637–664.

Benmelech, Efraim, Carola Frydman, and Dimitris Papanikolaou, "Financial Frictions and Employment during the Great Depression," *Journal of Financial Economics*, 2019, *133* (3), 541–563.

__ , **Nittai Bergman, and Amit Seru**, "Financing Labor," *Review of Finance*, 2021, *25* (5), 1365–1393.

Berger, David W, Kyle F Herkenhoff, and Simon Mongey, "Minimum Wages, Efficiency and Welfare," Technical Report, National Bureau of Economic Research 2024.

Bertrand, Marianne and Sendhil Mullainathan, "Enjoying the Quiet Life? Corporate Governance and Managerial Preferences," *Journal of Political Economy*, 2003, *111* (5), 1043–1075.

_ , **Esther Duflo, and Sendhil Mullainathan**, "How Much Should We Trust Differences-in-Differences Estimates?," *The Quarterly Journal of Economics*, 2004, *119* (1), 249–275.

Beuselinck, Christof, Garen Markarian, and Arnt Verriest, "Employee Protection Shocks and Corporate Cash Holdings," *Journal of Corporate Finance*, 2021, *69*, 102027.

Bird, Robert C and Donald J Smythe, "The Structure of American Legal Institutions and the Diffusion of Wrongful-Discharge Laws, 1978–1999," *Law & Society Review*, 2008, *42* (4), 833–864.

Bloom, Nicholas and John Van Reenen, "Measuring and Explaining Management Practices across Firms and Countries," *The Quarterly Journal of Economics*, 2007, *122* (4), 1351–1408.

Boeri, Tito and Juan F Jimeno, "The Effects of Employment Protection: Learning from Variable Enforcement," *European Economic Review*, 2005, *49* (8), 2057–2077.

Botero, Juan C, Simeon Djankov, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer, "The Regulation of Labor," *The Quarterly Journal of Economics*, 2004, *119* (4), 1339–1382.

Boxold, David, *Employment Practice Liability: Jury Award Trends and Statistics*, Horsham, PA: LRP Publications, 2008.

Bresnahan, Timothy F, Erik Brynjolfsson, and Lorin M Hitt, "Information Technology, Workplace Organization, and the Demand for Skilled Labor: Firm-Level Evidence," *The Quarterly Journal of Economics*, 2002, *117* (1), 339–376.

Caggese, Andrea, Vicente Cuñat, and Daniel Metzger, "Firing the Wrong Workers: Financing Constraints and Labor Misallocation," *Journal of Financial Economics*, 2019, *133* (3), 589–607.

Cengiz, Doruk, Arindrajit Dube, Attila Lindner, and Ben Zipperer, "The Effect of Minimum Wages on Low-Wage Jobs," *The Quarterly Journal of Economics*, 2019, *134* (3), 1405–1454.

Chava, Sudheer, András Danis, and Alex Hsu, "The Economic Impact of Right-to-Work Laws: Evidence from Collective Bargaining Agreements and Corporate Policies," *Journal of Financial Economics*, 2020, *137* (2), 451–469.

Chodorow-Reich, Gabriel, "The Employment Effects of Credit Market Disruptions: Firm-Level Evidence from the 2008–9 Financial Crisis," *The Quarterly Journal of Economics*, 2014, *129* (1), 1–59.

Cui, Chenyu, Kose John, Jiaren Pang, and Haibin Wu, "Employment Protection and Corporate Cash Holdings: Evidence from China's Labor Contract Law," *Journal of Banking & Finance*, 2018, *92*, 182–194.

Dang, Viet A, Amedeo De Cesari, and Hieu V Phan, "Employment Protection and Share Repurchases: Evidence from Wrongful Discharge Laws," *Journal of Corporate Finance*, 2021, *69*, 102036.

Daruich, Diego, Sabrina Di Addario, and Raffaele Saggio, "The Effects of Partial Employment Protection Reforms: Evidence from Italy," *The Review of Economic Studies*, 02 2023, *90* (6), 2880–2942.

De Ridder, Maarten and Damjan Pfajfar, "Policy Shocks and Wage Rigidities: Empirical Evidence from Regional Effects of National Shocks," 2017.

Derenoncourt, Ellora and Claire Montialoux, "Minimum Wages and Racial Inequality," *The Quarterly Journal of Economics*, 2021, *136* (1), 169–228.

Dertouzos, James N. and Lynn A. Karoly, *Labor Market Responses to Employer Liability*, Santa Monica, CA: RAND Corporation, 1992.

Dertouzos, James N and Lynn A Karoly, "Employment Effects of Worker Protection: Evidence from the United States," *Employment Security and Labor Market Behavior: Interdisciplinary Approaches and International Evidence*, 1993, pp. 215–27.

__ **, Elaine Holland, and Patricia Anne Ebener**, *The Legal and Economic Consequences of Wrongful Termination*, Rand Corporation Santa Monica, CA, 1988.

Dodini, Samuel, Anna Stansbury, and Alexander Willén, "How Do Firms Respond to Unions?," *NHH Dept. of Economics Discussion Paper*, 2024, (25).

__ **, Kjell G Salvanes, Alexander Willén, and Li Zhu**, "The Career Effects of Union Membership," *NHH Dept. of Economics Discussion Paper*, 2023, (12).

Dustmann, Christian, Attila Lindner, Uta Schönberg, Matthias Umkehrer, and Philipp vom Berge, "Reallocation Effects of the Minimum Wage*," *The Quarterly Journal of Economics*, 08 2022, *137* (1), 267–328.

Duygan-Bump, Burcu, Alexey Levkov, and Judit Montoriol-Garriga, "Financing Constraints and Unemployment: Evidence from the Great Recession," *Journal of Monetary Economics*, 2015, *75*, 89–105.

Ellul, Andrew and Marco Pagano, "Corporate Leverage and Employees' Rights in Bankruptcy," *Journal of Financial Economics*, 2019, *133* (3), 685–707.

Engbom, Niklas and Christian Moser, "Earnings Inequality and the Minimum Wage: Evidence from Brazil," *American Economic Review*, 2022, *112* (12), 3803–3847.

Fairhurst, Douglas DJ, Yanguang Liu, and Xiaoran Ni, "Employment Protection and Tax Aggressiveness: Evidence from Wrongful Discharge Laws," *Journal of Banking & Finance*, 2020, *119*, 105907.

Farber, Henry S, Daniel Herbst, Ilyana Kuziemko, and Suresh Naidu, "Unions and Inequality over the Twentieth Century: New Evidence from Survey Data," *The Quarterly Journal of Economics*, 2021, *136* (3), 1325–1385.

Fischer, Ronald and Diego Huerta, "Wealth Inequality and the Political Economy of Financial and Labour Regulations," *Journal of Public Economics*, 2021, *204*, 104553.

_ , _ , and Patricio Valenzuela, "The Inequality-Credit Nexus," *Journal of International Money and Finance*, 2019, *91*, 105 – 125.

Fonseca, Julia and Bernardus Van Doornik, "Financial Development and Labor Market Outcomes: Evidence from Brazil," *Journal of Financial Economics*, 2022, *143* (1), 550–568.

Garicano, Luis, Claire Lelarge, and John Van Reenen, "Firm Size Distortions and the Productivity Distribution: Evidence from France," *American Economic Review*, 2016, *106* (11), 3439–79.

Gourio, François and Nicolas Roys, "Size Dependent Regulations, Firm Size Distribution, and Reallocation," *Quantitative Economics*, 2014, *5* (2), 377–416.

Griffith, Rachel and Gareth Macartney, "Employment Protection Legislation, Multinational Firms, and Innovation," *Review of Economics and Statistics*, 2014, *96* (1), 135–150.

Hadlock, Charles J and Joshua R Pierce, "New Evidence on Measuring Financial Constraints: Moving Beyond the KZ Index," *The Review of Financial Studies*, 2010, *23* (5), 1909–1940.

Huerta, Diego, "The Political Economy of Labor Policy," 2024. https://www.diegohuertad.com/working_paper/labor_policy.

Jeffers, Jessica S, "The Impact of Restricting Labor Mobility on Corporate Investment and Entrepreneurship," *The Review of Financial Studies*, 2024, *37* (1), 1–44.

Johnson, Matthew S., Daniel Schwab, and Patrick Koval, "Legal Protection against Retaliatory Firing Improves Workplace Safety," *The Review of Economics and Statistics*, 09 2024, *106* (5), 1236–1253.

Jung, David J, "Jury Verdicts in Wrongful Termination Cases," *Public Law Research Institute Report, University of California Hastings College of the Law*, 1997.

Kaplan, Steven N and Luigi Zingales, "Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financing Constraints?," *The Quarterly Journal of Economics*, 1997, *112* (1), 169–215.

Karpuz, Ahmet, Kirak Kim, and Neslihan Ozkan, "Employment Protection Laws and Corporate Cash Holdings," *Journal of Banking & Finance*, 2020, *111*, 105705.

Knepper, Matthew, "From the Fringe to the Fore: Labor unions and Employee Compensation," *Review of Economics and Statistics*, 2020, *102* (1), 98–112.

Kugler, Adriana D and Gilles Saint-Paul, "How Do Firing Costs Affect Worker Flows in a World with Adverse Selection?," *Journal of Labor Economics*, 2004, *22* (3), 553–584.

Lamont, Owen, Christopher Polk, and Jesús Saaá-Requejo, "Financial Constraints and Stock Returns," *The Review of Financial Studies*, 2001, *14* (2), 529–554.

Li, Tongxia, Tze Chuan'Chewie'Ang, and Chun Lu, "Employment Protection and the Provision of Trade Credit," *Journal of Banking & Finance*, 2023, *155*, 106991.

Lian, Chen and Yueran Ma, "Anatomy of Corporate Borrowing Constraints," *The Quarterly Journal of Economics*, 2021, *136* (1), 229–291.

Mehrotra, Neil and Dmitriy Sergeyev, "Financial Shocks, Firm Credit and the Great Recession," *Journal of Monetary Economics*, 2021, *117*, 296–315.

Micco, Alejandro and Pablo Muñoz, "The Impact of Extending Employment Protection to Agency Workers on Firms," *American Economic Journal: Macroeconomics*, 2024, *16* (1), 66–101.

Michaels, Ryan, T Beau Page, and Toni M Whited, "Labor and Capital Dynamics under Financing Frictions," *Review of Finance*, 2019, *23* (2), 279–323.

Miles, Thomas J, "Common Law Exceptions to Employment at Will and US Labor Markets," *Journal of Law, Economics, and Organization*, 2000, *16* (1), 74–101.

Morriss, Andrew P, "Exploding Myths: An Empirical and Economic Rassessment of the Rise of Employment At-Will," *Mo. L. REv.*, 1994, *59*, 679.

Olden, Andreas and Jarle Møen, "The Triple Difference Estimator," *The Econometrics Journal*, 2022, *25* (3), 531–553.

Pagano, Marco and Giovanni Pica, "Finance and Employment," *Economic Policy*, 2012, *27* (69), 5–55.

_ **and Paolo F. Volpin**, "The Political Economy of Corporate Governance," *American Economic Review*, 2005, *95* (4), 1005–30.

Perotti, Enrico C. and Ernst-Ludwig von Thadden, "The Political Economy of Corporate Control and Labor Rents," *Journal of Political Economy*, 2006, *114*, 145–74.

Serfling, Matthew, "Firing Costs and Capital Structure Decisions," *The Journal of Finance*, 2016, *71* (5), 2239–2286.

Simintzi, Elena, Vikrant Vig, and Paolo Volpin, "Labor Protection and Leverage," *The Review of Financial Studies*, 2015, *28* (2), 561–591.

Strezhnev, Anton, "Decomposing Triple-Differences Regression under Staggered Adoption," *arXiv preprint arXiv:2307.02735*, 2023.

_ , "Group-Specific Linear Trends and the Triple-Differences in Time Design," Technical Report, Center for Open Science 2024.

Vergara, Damian, "Minimum Wages and Optimal Redistribution: The Role of Firm Profits," Technical Report, Working Paper 2023.

Walsh, David J and Joshua L Schwarz, "State Common Law Wrongful Discharge Doctrines: Up-Date, Refinement, and Rationales," *American Business Law Journal*, 1995, *33*, 645.

Whited, Toni M and Guojun Wu, "Financial Constraints Risk," *The Review of Financial Studies*, 2006, *19* (2), 531–559.

Zhuang, Castiel Chen, "A Way to Synthetic Triple Difference," *arXiv preprint arXiv:2409.12353*, 2024.

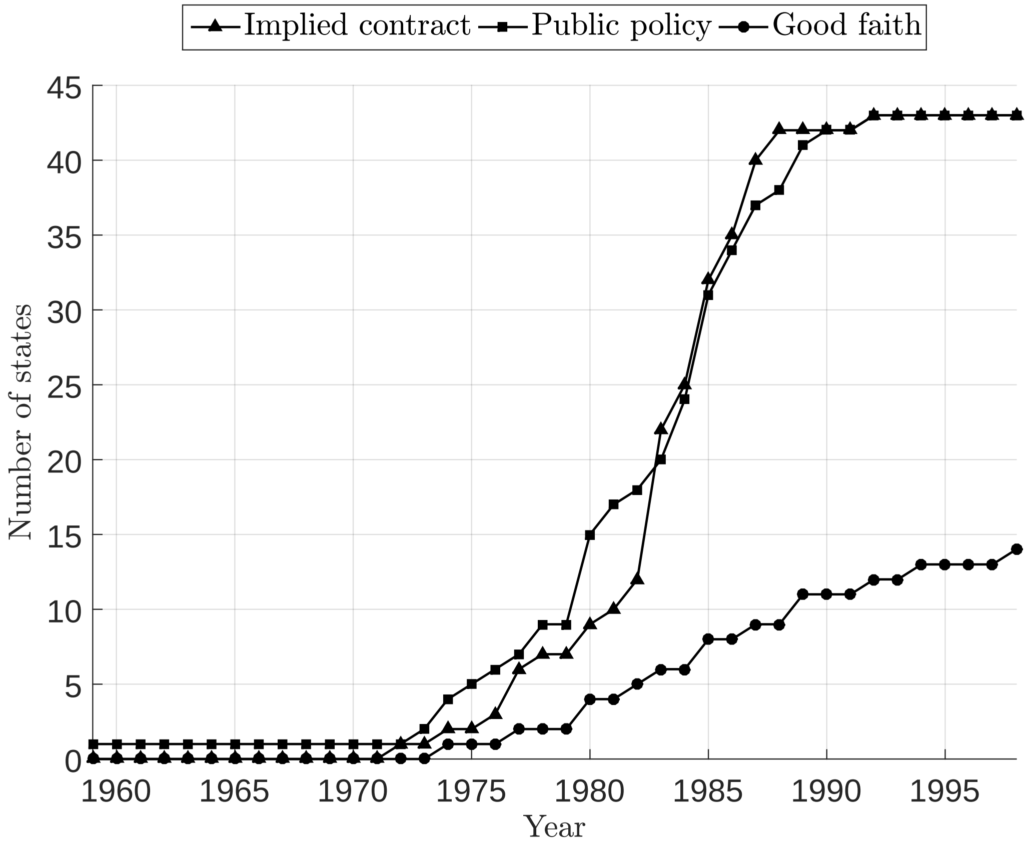
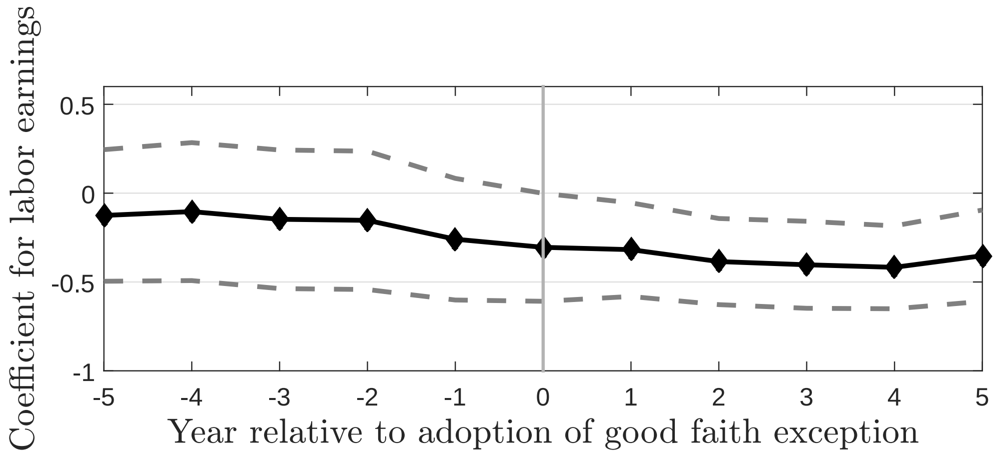


Figure 3: Number of states adopting Wrongful Discharge Laws (WDLs)

This figure shows the number of states that adopted the implied contract, public policy, and *good faith exception* between 1959 and 1998.

(a) The *good faith exception* and labor earnings



(b) The *good faith exception* and EBIT

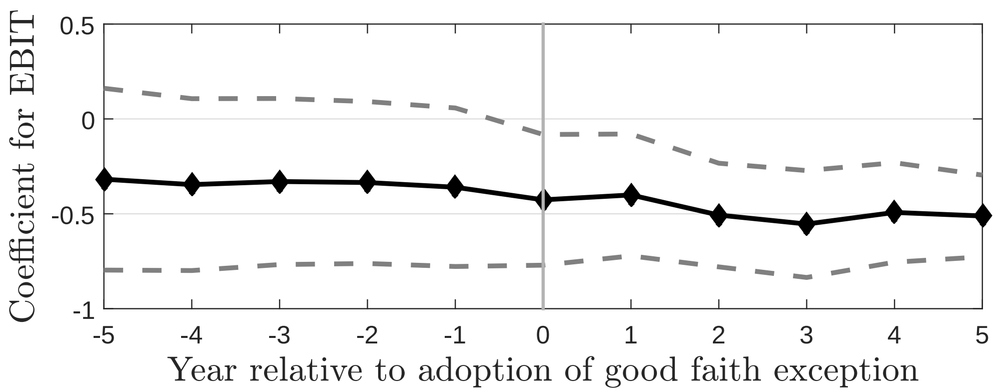


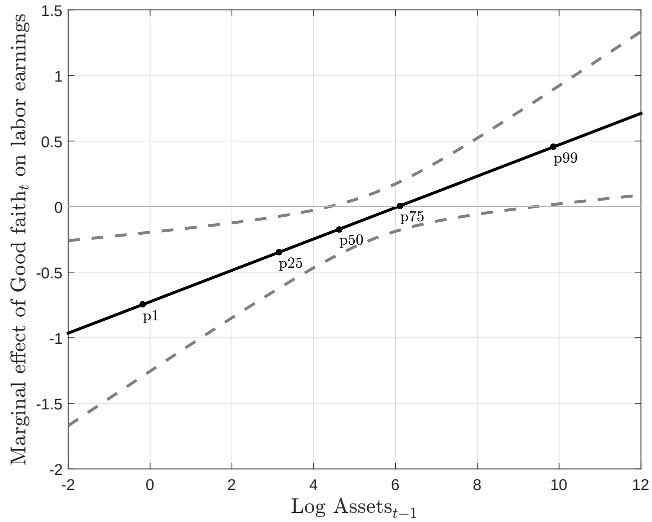
Figure 4: Effect of the passage of the *good faith exception* on labor earnings and EBIT

This figure shows the effect of the *good faith exception* adoption on Compustat labor earnings and EBIT. Both variables are scaled by their sample mean. The y-axis presents the coefficients from regressing labor earnings or EBIT on dummy variables indicating the year relative to the good faith adoption and year fixed effects. Dummies are for up to 5 years before and after the good faith adoption. The x-axis shows the years relative to the good faith adoption. The dashed lines are the 90% confidence intervals for the estimated coefficients. Standard errors are clustered by state. The graph shows the point estimates and 90% confidence intervals of the the parameters β^{τ} from the following regression:

$$y_{i,s,t} = \omega_t + \sum_{\tau=-10}^{10} \beta^{\tau} \times \text{Good faith}_{s,t}^{\tau} + \varepsilon_{i,s,t},$$

where $y_{i,s,t}$ are labor earnings or EBIT in year t in firm i in state s. Good faith$_{s,t}^{\tau}$ is a dummy variable indicating the year relative to the enactment of the *good faith exception* in state s and year t.

(a) The *good faith exception* and labor earnings



(b) The *good faith exception* and EBIT

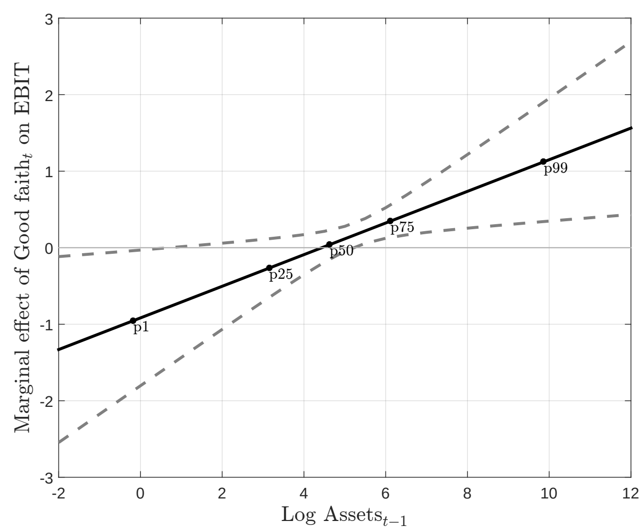


Figure 5: Effect of the passage of the *good faith exception* on labor earnings and EBIT as a function of log assets

The figure shows the marginal effect of the *good faith exception* adoption (Good faith$_t$ = 1) on Compustat labor earnings or EBIT conditional on log assets at $t-1$ (Log Assets$_{t-1}$). Calculations are based on the estimated coefficients presented in columns (4) of Tables 5 and 7. The black solid line presents the marginal effect of Good faith$_t$ = 1 on labor earnings or EBIT according to expression (5.2). The dashed lines correspond to the 90% confidence intervals obtained from applying the delta method. Standard errors are clustered by state. The black dots indicate the effect of Good faith$_t$ on labor earnings or EBIT for the 1st, 25th, 50th, 75th and 99th percentiles of log assets. The effects on labor earnings or EBIT are in terms of the percentage change (in decimal form) relative to the mean.

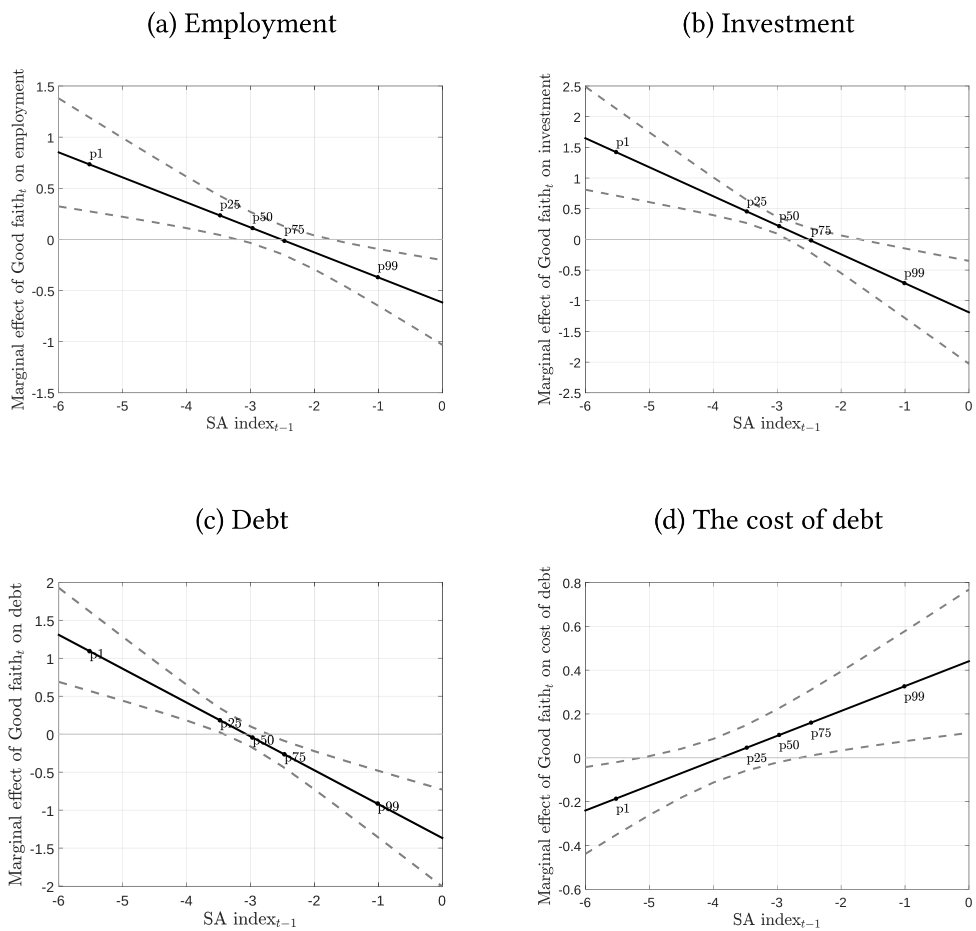


Figure 6: Effect of the *good faith exception* adoption on employment, investment, debt, and the cost of debt as a function of SA index

The figure shows the marginal effect of the *good faith exception* adoption (Good faith$_t$ = 1) on employment, investment, debt, and the cost of debt conditional on the Hadlock and Pierce index at $t-1$ (SA index$_{t-1}$). A higher value of the SA index means greater financial constraints. Calculations are based on the estimated coefficients presented in column (4) of Table 10 and 11. The black solid line presents the marginal effect of Good faith$_t$ = 1 on employment, investment, debt, or the cost of debt according to expression (5.2). The dashed lines correspond to the 90% confidence intervals obtained from applying the delta method. Standard errors are clustered by state. The black dots indicate the effect of Good faith$_t$ on employment, investment, debt, or the cost of debt for the 1st, 25th, 50th, 75th and 99th percentiles of SA index. The effects presented on the y-axis are in terms of the percentage change (in decimal form) relative to the mean.

Table 1: Adoption of state-level Wrongful Discharge Laws (WDLs)

State	**Implied contract** *Month/year*	**Public Policy** *Month/year*	**Good faith** *Month/year*
Alabama	7/1987		
Alaska	5/1983	2/1986	5/1983
Arizona	6/1983 (Rev. 4/1984)	6/1985	6/1985
Arkansas	6/1984	3/1980	
California	3/1972	9/1959	10/1980
Colorado	10/1983	9/1985	
Connecticut	10/1985	1/1980	6/1980
Delaware		3/1992	4/1992
Florida			
Georgia			
Hawaii	8/1986	10/1982	
Idaho	4/1977	4/1977	8/1989
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	5/1988	5/1980	7/1977
Michigan	6/1980	6/1976	
Minnesota	4/1983	11/1986	
Mississippi	6/1992	7/1987	
Missouri	1/1983 (Rev. 2/1988)	11/1985	
Montana	6/1987	1/1980	1/1982
Nebraska	11/1983	11/1987	
Nevada	8/1983	1/1984	2/1987
New Hampshire	8/1988	2/1974	2/1974 (Rev. 5/1980)
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	12/1976	2/1989	5/1985 (Rev. 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	5/1986	3/1989	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	8/1985	7/1989	1/1994

The table reports the month and year that each state adopted the implied contract, public policy and good faith exceptions. The month and year that some states reversed any of the three exceptions appear in parenthesis.

Table 2: Sample statistics: disclosing and non-disclosing firms

	Compustat			CBP-Supplemented		Matching Imputation	
	Full	**Disclosing**	**Non-disclosing**	**Available**	**Not available**	**Available**	**Not available**
Number of observations	89,795	8,611	81,183	49,145	40,650	46,640	43,155
Number of firms	8,700	1,011	7,689	6,202	2,498	5,306	3,394
Means							
Assets (billion $)	1.30	4.94	0.97	1.39	1.32	1.39	1.32
Sales (billion $)	1.60	5.41	1.19	1.59	1.60	1.65	1.53
Employment (thousands)	6.89	20.18	5.59	6.50	7.71	7.00	7.05

The table reports the statistics for firms with available and non-available data on labor earnings from three sources. First, item *XLR* from Compustat. "Disclosing firms" are the ones that report total labor earnings in Compustat. Second, the *CBP-supplemented* labor expenses, obtained by multiplying the County Business Patterns (CBP) average wages and benefits (state, four-digit industry code, and firm size level) by firm employment from Compustat. Third, the imputed labor earnings for non-disclosing firms through matching them with similar disclosing firms (*Matching Imputation*). Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions.

Table 3: Summary statistics for restricted sample and full sample

	Restricted sample					Full sample				
	Mean	**Std. Dev**	**P25**	**Median**	**P75**	**Mean**	**Std. Dev**	**P25**	**Median**	**P75**
Dependent variables										
Labor earnings$_t$ (Compustat)	1.23	1.95	0.08	0.35	1.50	-	-	-	-	-
Labor earnings$_t$ (CBP-Supplemented)	1.16	1.95	0.05	0.27	1.35	0.36	1.19	0.01	0.04	0.18
Labor earnings$_t$ (Matching Imputation)	0.89	1.23	0.07	0.31	1.21	0.40	0.80	0.02	0.09	0.34
Employment$_t$	20.17	33.35	1.64	6.26	25.30	7.02	22.20	0.26	1.12	4.30
EBIT$_t$	0.56	1.58	0.01	0.09	0.47	0.15	0.71	0.00	0.01	0.06
EBITDA$_t$	0.83	2.20	0.03	0.14	0.72	0.21	1.02	0.00	0.02	0.09
Capital expenditures$_t$	0.49	1.25	0.01	0.07	0.39	0.12	0.58	0.00	0.01	0.04
Debt$_t$	1.17	2.64	0.02	0.16	1.07	0.36	1.52	0.00	0.03	0.15
Cost of debt$_t$	0.11	0.28	0.07	0.09	0.11	0.22	7.68	0.07	0.09	0.12
Main explanatory variable										
Good faith$_t$	0.08	0.27	0.00	0.00	0.00	0.16	0.37	0.00	0.00	0.00
Control variables										
Implied contract$_t$	0.35	0.48	0.00	0.00	1.00	0.49	0.50	0.00	0.00	1.00
Public policy$_t$	0.33	0.47	0.00	0.00	1.00	0.44	0.50	0.00	0.00	1.00
Assets$_{t-1}$	4.77	11.32	0.17	0.82	4.61	1.30	5.43	0.04	0.15	0.57
Profitability$_{t-1}$	0.02	0.18	0.02	0.03	0.05	0.01	0.23	0.01	0.02	0.05
Fixed assets$_{t-1}$	0.45	0.22	0.28	0.43	0.63	0.33	0.21	0.17	0.29	0.45
Market to book$_{t-1}$	4.65	6.96	1.73	2.63	4.80	4.41	9.82	1.58	2.42	4.46
Dividend payer$_t$	0.75	0.43	1.00	1.00	1.00	0.48	0.50	0.00	0.00	1.00
Modified z-score$_{t-1}$	2.13	2.73	1.63	2.40	3.09	1.89	8.32	1.38	2.36	3.13
Book leverage$_{t-1}$	0.24	0.19	0.11	0.22	0.32	0.26	0.38	0.09	0.23	0.37
Sales$_t$	5.40	13.09	0.27	1.10	5.50	1.60	6.09	0.05	0.22	0.84
Capital expenditures$_{t-1}$	0.48	1.22	0.01	0.06	0.38	0.12	0.57	0.00	0.01	0.04
Employment$_{t-1}$	19.88	32.70	1.57	6.00	25.00	6.89	21.93	0.25	1.08	4.16
State per capita GDP$_{t-1}$	36.78	5.02	33.39	36.45	40.17	38.17	5.32	34.57	38.08	41.78
State GDP growth$_{t-1}$	0.02	0.04	0.00	0.03	0.05	0.02	0.04	-0.01	0.02	0.05
Circuit good faith$_{t-1}$	0.07	0.16	0.00	0.00	0.00	0.12	0.20	0.00	0.00	0.25
Union Membership$_t$	21.84	9.60	12.90	22.50	30.10	20.90	8.92	13.10	21.10	27.90
Right-to-work$_t$	0.32	0.47	0.00	0.00	1.00	0.28	0.45	0.00	0.00	1.00
Political balance$_t$	0.62	0.16	0.51	0.59	0.70	0.61	0.15	0.52	0.59	0.68

This table reports summary statistics for the restricted and full sample. The full sample corresponds to Compustat firms (excluding financials and utilities) over the period 1967 to 1995 and consists of 89,795 observations. The restricted sample consists of Compustat firms that disclose total labor earnings (8,613 observations). EBIT is earnings before interest and taxes. EBITDA is earnings before interest, taxes and depreciation. Labor earnings, EBIT, EBITDA, Assets, Sales, Capital expenditures, Debt, and State per capita GDP are in billion dollars. Employment is in thousands of workers. Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions.

Table 4: Sample means, treatment and control firms

	Restricted sample				Full sample			
	Treatment		Control		Treatment		Control	
	Mean	**Std. Dev**	**Mean**	**Std. Dev**	**Mean**	**Std. Dev**	**Mean**	**Std. Dev**
Dependent variables								
Labor earnings$_t$ (Compustat)	0.82***	1.75	1.26	1.96	-	-	-	-
Labor earnings$_t$ (CBP-Supplemented)	0.87***	1.95	1.20	1.94	0.21***	0.82	0.40	1.26
Labor earnings$_t$ (Matching Imputation)	0.58***	1.11	0.92	1.23	0.35**	0.83	0.40	0.80
Employment$_t$	15.18***	34.16	20.59	33.25	3.89***	13.6	7.64	23.48
EBIT$_t$	0.48	1.31	0.56	1.60	0.07***	0.4	0.16	0.76
EBITDA$_t$	0.78	2.03	0.83	2.22	0.12***	0.62	0.23	1.08
Capital expenditures$_t$	0.51	1.42	0.49	1.23	0.07***	0.41	0.13	0.61
Debt$_t$	1.21	3.25	1.17	2.58	0.19***	0.99	0.40	1.59
Cost of debt$_t$	0.13*	0.21	0.11	0.28	0.24	4.01	0.22	8.17
Control variables								
Implied contract$_t$	0.73***	0.00	0.32	0.47	0.8***	0.4	0.43	0.50
Public policy$_t$	0.94***	0.44	0.28	0.45	0.96***	0.18	0.34	0.47
Assets$_{t-1}$	4.59	0.23	4.78	11.29	0.75***	3.69	1.41	5.70
Profitability$_{t-1}$	-0.01***	11.63	0.02	0.12	-0.02***	0.35	0.01	0.19
Fixed assets$_{t-1}$	0.43**	0.47	0.45	0.22	0.27***	0.2	0.34	0.21
Market to book$_{t-1}$	3.92***	0.26	4.71	7.01	4.04***	7.37	4.48	10.23
Dividend payer$_t$	0.46***	6.31	0.78	0.42	0.27***	0.44	0.52	0.50
Modified z-score$_{t-1}$	1.18***	0.50	2.21	2.55	1.14***	5.26	2.03	8.78
Book leverage$_{t-1}$	0.25***	4.19	0.23	0.18	0.23***	0.35	0.26	0.39
Sales$_t$	4.41**	0.28	5.49	13.22	0.92***	4.09	1.73	6.39
Capital expenditures$_{t-1}$	0.52	11.43	0.47	1.20	0.07***	0.43	0.13	0.59
Employment$_{t-1}$	15.13***	1.5	20.3	32.6	3.82***	13.5	7.50	23.19
State per capita GDP$_{t-1}$	41.4***	33.41	36.4	4.82	42.54***	4.71	37.32	5.00
State GDP growth$_{t-1}$	0.02	5.07	0.02	0.04	0.02***	0.04**	0.02	0.04
Circuit good faith$_{t-1}$	0.45***	0.04	0.04	0.11	0.44***	0.19	0.05	0.13
Union Membership$_t$	18.68***	0.19	22.11	9.86	19.03***	3.74	21.26	9.57
Right-to-work$_t$	0.15***	4.54	0.33	0.47	0.09***	0.28	0.32	0.47
Political balance$_t$	0.6***	0.36	0.62	0.16	0.62***	0.11	0.61	0.15

This table compares the mean values and standard deviations for treatment (firms headquartered in states that adopt the *good faith exception*) and control firms (firms headquartered in states that do not adopt the *good faith exception*). It considers both the restricted and full sample. In the columns labeled 'Treatment', *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively, for a t-test of whether the means of the treatment and control groups are equal. The full sample corresponds to Compustat firms (excluding financials and utilities) over the period 1967 to 1995 and consists of 89,795 observations. The restricted sample consists of Compustat firms that disclose total labor earnings (8,613 observations). EBIT is earnings before interest and taxes. EBITDA is earnings before interest, taxes and depreciation. Labor earnings, EBIT, EBITDA, Assets, Sales, Capital expenditures, Debt, and State per capita GDP are in billion dollars. Employment is in thousands of workers. Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions.

Table 5: The good faith exception and Compustat labor earnings

	Labor earnings (Compustat)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Good faith$_t$	-0.668**	-0.719**	-0.912	-0.726**	-0.825**	-0.861	-0.838**
	(0.331)	(0.317)	(0.587)	(0.322)	(0.366)	(0.578)	(0.377)
Good faith$_t$ × Log Assets$_{t-1}$	0.105*	0.111*	0.159**	0.120**	0.126*	0.164**	0.136**
	(0.0600)	(0.0578)	(0.0680)	(0.0557)	(0.0635)	(0.0703)	(0.0609)
Log Assets$_{t-1}$	0.358***	0.388***	0.462***	0.377***	0.0804	0.116	0.0744
	(0.0765)	(0.0770)	(0.0890)	(0.0760)	(0.0836)	(0.105)	(0.0826)
Implied contract$_t$	-0.0369	-0.0684	0.0266	-0.0920	-0.0126	0.0745	-0.0462
	(0.197)	(0.195)	(0.198)	(0.200)	(0.226)	(0.216)	(0.229)
Public policy$_t$	0.352**	0.352**	0.352**	0.352**	0.303*	0.244*	0.333**
	(0.158)	(0.158)	(0.158)	(0.158)	(0.161)	(0.137)	(0.159)
Profitability$_{t-1}$		-0.00708	-0.0452	-0.00642			
		(0.0422)	(0.0489)	(0.0414)			
Fixed assets$_{t-1}$		0.0723	0.168	0.0722			
		(0.133)	(0.122)	(0.129)			
Market to book$_{t-1}$		-0.00521*	-0.00346	-0.00521**			
		(0.00260)	(0.00227)	(0.00253)			
Dividend payer$_t$		-0.0236	-0.0118	-0.0195			
		(0.0798)	(0.0939)	(0.0797)			
Modified z-score$_{t-1}$		-0.0277***	-0.0294***	-0.0262***			
		(0.00687)	(0.00737)	(0.00677)			
Book leverage$_{t-1}$		-0.186*	-0.205**	-0.160	-0.0792	-0.0648	-0.0583
		(0.103)	(0.0935)	(0.102)	(0.102)	(0.102)	(0.104)
Log Sales$_t$					0.166**	0.196**	0.164**
					(0.0644)	(0.0734)	(0.0656)
Log Capital expenditures$_{t-1}$					0.00537	-0.00728	0.00407
					(0.0196)	(0.0203)	(0.0193)
Log Employment$_{t-1}$					0.247**	0.326**	0.245**
					(0.114)	(0.137)	(0.113)
State per capita GDP$_{t-1}$				0.691**			0.752**
				(0.339)			(0.363)
State GDP growth$_{t-1}$				-0.425			-0.575
				(0.385)			(0.395)
Circuit good faith$_{t-1}$				-0.285			-0.293
Observations	8,613	8,613	8,374	8,613	8,089	7,813	8,089
Adjusted R-squared	0.929	0.930	0.931	0.930	0.930	0.933	0.931
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	NO	NO	YES	NO	NO	YES	NO

This table presents the results from OLS regressions relating labor earnings to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. Labor earnings are measured by item *XLR* from Compustat. Labor earnings are scaled by their sample mean. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions. Columns (2) to (4) use the control variables from Serfling (2016), columns (5) to (7) use the controls from Michaels et al. (2019). All regressions include firm fixed effects, state-level fixed effects, and industry-year fixed effects. Columns (3) and (6) also include state-year fixed effects. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 6: The good faith exception and alternative measures for labor earnings

	Labor earnings (CBP-Supplemented)				Labor earnings (Matching Imputation)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Good faith$_t$	-0.423*	-0.295	-0.442*	-0.294	-0.722**	-0.538*	-0.453*	-0.361
	(0.234)	(0.226)	(0.247)	(0.237)	(0.356)	(0.295)	(0.269)	(0.231)
Good faith$_t$ × Log Assets$_{t-1}$	0.0988**	0.0846*	0.0975*	0.0876	0.111*	0.110**	0.0616	0.0831**
	(0.0470)	(0.0503)	(0.0490)	(0.0531)	(0.0620)	(0.0502)	(0.0504)	(0.0400)
Log Assets$_{t-1}$	0.509***	0.503***	0.179**	0.166**	0.408***	0.407***	0.0829**	0.0790**
	(0.0706)	(0.0702)	(0.0742)	(0.0690)	(0.0395)	(0.0393)	(0.0350)	(0.0346)
Implied contract$_t$	0.303	0.308	0.281	0.278	0.188	0.129	0.143	0.102
	(0.185)	(0.218)	(0.197)	(0.238)	(0.202)	(0.225)	(0.190)	(0.212)
Public policy$_t$	0.633**	0.630***	0.700**	0.646**	-0.0928	-0.0479	-0.0823	-0.0625
	(0.264)	(0.228)	(0.298)	(0.248)	(0.173)	(0.160)	(0.157)	(0.153)
Profitability$_{t-1}$	0.0754**	0.0743**			0.119***	0.107***		
	(0.0355)	(0.0355)			(0.0314)	(0.0330)		
Fixed assets$_{t-1}$	0.425**	0.425**			0.223**	0.224**		
	(0.184)	(0.181)			(0.102)	(0.101)		
Market to book$_{t-1}$	0.00374*	0.00357			-0.000104	-0.000189		
	(0.00216)	(0.00216)			(0.000755)	(0.000681)		
Dividend payer$_t$	0.101**	0.0991*			0.0237	0.0305		
	(0.0463)	(0.0497)			(0.0227)	(0.0236)		
Modified z-score$_{t-1}$	-0.0165***	-0.0167***			-0.0228***	-0.0225***		
	(0.00258)	(0.00262)			(0.00401)	(0.00411)		
Book leverage$_{t-1}$	-0.0590	-0.0535	-0.0362	-0.0279	-0.0977**	-0.115**	-0.0126	-0.0284
	(0.0389)	(0.0343)	(0.0385)	(0.0326)	(0.0445)	(0.0458)	(0.0427)	(0.0407)
Log Sales$_t$			0.116***	0.114***			0.147***	0.148***
			(0.0207)	(0.0216)			(0.0254)	(0.0253)
Log Capital expenditures$_{t-1}$			-0.00737	-0.00925			-0.00540	-0.00435
			(0.00826)	(0.00847)			(0.00582)	(0.00558)
Log Employment$_{t-1}$			0.345***	0.355***			0.295***	0.295***
			(0.0796)	(0.0781)			(0.0407)	(0.0390)
State per capita GDP$_{t-1}$		0.421		0.443		0.0979		-0.0284
		(0.354)		(0.351)		(0.191)		(0.0407)
State GDP growth$_{t-1}$		-0.320		-0.417		0.130		0.0742
		(0.447)		(0.448)		(0.257)		(0.175)
Circuit good faith$_{t-1}$		-0.144		-0.144		-0.434***		-0.0185
		(0.216)		(0.225)		(0.148)		(0.246)
Observations	49,159	49,237	47,288	47,357	46,542	46,652	46,252	46,344
Adjusted R-squared	0.906	0.906	0.907	0.907	0.860	0.859	0.866	0.866
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating labor earnings to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. In columns (1) to (4), labor earnings are constructed by supplementing Compustat data with four-digit industry code, state, and firm size level average annual wage and benefits from County Business Patterns (CBP). In columns (5) to (8), labor earnings are imputed by matching non-disclosing firms to similar disclosing firms from Compustat. Labor earnings are scaled by their sample mean. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions. Columns (1)-(2) and (5)-(6) use the control variables from Serfling (2016), columns (3)-(4) and (7)-(8) use the controls from Michaels et al. (2019). All regressions include firm fixed effects, state-level fixed effects, and industry-year fixed effects. Odd columns also include state-year fixed effects. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 7: The good faith exception and firm earnings

	Full sample						Restricted sample			
	EBIT				EBITDA		EBIT		EBITDA	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Good faith$_t$	-0.804*	-0.809*	-0.858	-0.756*	-0.722	-0.677*	-3.078*	-2.059*	-2.200**	-1.538*
	(0.451)	(0.448)	(0.520)	(0.444)	(0.435)	(0.365)	(1.561)	(1.181)	(1.085)	(0.783)
Good faith$_t$ × Log Assets$_{t-1}$	0.166*	0.167*	0.177*	0.170**	0.154**	0.153**	0.387*	0.339*	0.299*	0.252**
	(0.0844)	(0.0838)	(0.0910)	(0.0831)	(0.0758)	(0.0664)	(0.223)	(0.169)	(0.154)	(0.111)
Log Assets$_{t-1}$	0.422***	0.423***	0.426***	0.425***	0.347***	0.344***	0.471***	0.427***	0.433***	0.377***
	(0.0770)	(0.0798)	(0.0852)	(0.0810)	(0.0550)	(0.0519)	(0.136)	(0.112)	(0.109)	(0.0914)
Implied contract$_t$	0.396	0.393	0.461	0.400	0.0155	-0.0906	0.657	0.436	0.281	0.113
	(0.608)	(0.611)	(0.538)	(0.609)	(0.380)	(0.432)	(0.626)	(0.683)	(0.455)	(0.491)
Public policy$_t$	0.913	0.909	0.781	0.897	0.351	0.413	1.370***	1.458**	0.945***	1.025***
	(0.559)	(0.559)	(0.560)	(0.555)	(0.344)	(0.344)	(0.380)	(0.555)	(0.240)	(0.366)
Profitability$_{t-1}$		-0.0158	-0.00720	-0.0174	-0.0232	-0.0300*	-0.167*	-0.00223	-0.105	0.0165
		(0.0212)	(0.0240)	(0.0210)	(0.0198)	(0.0178)	(0.0923)	(0.0762)	(0.0691)	(0.0536)
Fixed assets$_{t-1}$		0.0130	0.0566	0.0152	0.335**	0.312**	-0.264	-0.410	-0.0456	-0.183
		(0.187)	(0.206)	(0.187)	(0.141)	(0.131)	(0.496)	(0.377)	(0.321)	(0.241)
Market to book$_{t-1}$		0.00287***	0.00298***	0.00284***	0.00115*	0.00112*	-0.00228	-0.00360	-0.00286	-0.00412
		(0.000891)	(0.000916)	(0.000902)	(0.000634)	(0.000667)	(0.00365)	(0.00474)	(0.00267)	(0.00378)
Dividend payer$_t$		0.0907*	0.109**	0.0921*	0.0827**	0.0722**	-0.0121	-0.0303	-0.0212	-0.0239
		(0.0503)	(0.0528)	(0.0502)	(0.0369)	(0.0356)	(0.0810)	(0.0627)	(0.0701)	(0.0526)
Modified z-score$_{t-1}$		-0.000870	-0.000883	-0.000866	-0.00224	-0.00219	-0.00429	-0.0140	-0.0125	-0.0187**
		(0.00186)	(0.00197)	(0.00184)	(0.00177)	(0.00169)	(0.0163)	(0.0113)	(0.0118)	(0.00854)
Book leverage$_{t-1}$		-0.0342	-0.0355	-0.0352	-0.0306	-0.0300	-0.0917	0.0186	-0.0781	0.0172
		(0.0373)	(0.0381)	(0.0370)	(0.0277)	(0.0269)	(0.191)	(0.180)	(0.146)	(0.134)
State per capita GDP$_{t-1}$				-0.380		-0.387		0.898		0.673
				(0.397)		(0.313)		(0.997)		(0.737)
State GDP growth$_{t-1}$				0.398		0.300		-0.233		-0.553
				(0.481)		(0.301)		(0.670)		(0.494)
Circuit good faith$_{t-1}$				-0.238		-0.315**		0.0779		-0.0311
				(0.172)		(0.145)		(0.559)		(0.395)
Observations	89,852	89,852	89,794	89,852	89,737	89,795	8,374	8,613	8,372	8,611
Adjusted R-squared	0.828	0.828	0.827	0.828	0.891	0.891	0.848	0.851	0.915	0.915
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	NO	NO	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating EBIT and EBITDA to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. EBIT and EBITDA are normalized by their sample mean. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. Table A1 in the Appendix provides variable definitions. Columns (1) to (6) use the full sample, columns (7) to (10) use the restricted sample. All regressions include firm fixed effects, state-level fixed effects and industry-year fixed effects. Columns (3),(5), (7) and (9) also include state-year fixed effects. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 8: Financial constraints and labor earnings

	Labor earnings (Compustat)								Labor earnings (CBP-Supplemented)		Labor earnings (Matching Imputation)	
	Hadlock and Pierce (2010)		Kaplan and Zingales (1997)		Whited and Wu (2006)		Non-dividend payer		Hadlock and Pierce (2010)		Hadlock and Pierce (2010)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
	Controls: Serfling (2016)											
Good faith$_t$	-0.438	-0.646	0.0258	0.154	0.0287	0.150	0.104	0.251	-0.697	-0.654	-0.809	-0.507
	(0.549)	(0.388)	(0.314)	(0.116)	(0.313)	(0.112)	(0.336)	(0.166)	(0.422)	(0.410)	(0.610)	(0.524)
Financial constraint$_{t-1}$	0.391***	0.345**	-0.00103***	-0.000406	-0.174**	-0.130**	0.0163	-0.00419	-0.183	-0.157	-0.196	-0.205
	(0.0915)	(0.133)	(0.000364)	(0.000318)	(0.0800)	(0.0595)	(0.0885)	(0.0806)	(0.128)	(0.130)	(0.127)	(0.124)
Good faith$_t$ × Financial constraint$_{t-1}$	-0.165	-0.207*	-0.000510	-0.000802	0.00408	-0.00364	-0.239	-0.334**	-0.261*	-0.249*	-0.192	-0.178
	(0.116)	(0.122)	(0.000770)	(0.000869)	(0.0455)	(0.00413)	(0.211)	(0.156)	(0.133)	(0.137)	(0.205)	(0.149)
Observations	6,761	7,030	7,004	7,195	6,741	6,945	8,374	8,613	43,606	43,686	38,823	38,943
Adjusted R-squared	0.931	0.929	0.938	0.937	0.939	0.938	0.925	0.925	0.905	0.905	0.864	0.864
	Controls: Michaels et al. (2019)											
Good faith$_t$	-0.0131	-0.622	0.128	0.170	0.134	0.166	0.258	0.257	-0.498	-0.442	-0.777	-0.610
	(0.482)	(0.376)	(0.270)	(0.119)	(0.267)	(0.117)	(0.280)	(0.165)	(0.392)	(0.381)	(0.539)	(0.472)
Financial constraint$_{t-1}$	0.797***	0.807***	-0.00550***	-0.00647***	-0.0896	-0.0381	0.0460	0.0412	1.130***	1.154***	0.898***	0.895***
	(0.179)	(0.251)	(0.00188)	(0.00196)	(0.0670)	(0.0517)	(0.0948)	(0.0869)	(0.210)	(0.212)	(0.134)	(0.138)
Good faith$_t$ × Financial constraint$_{t-1}$	-0.0958	-0.208*	0.00627	0.00183	0.00989	-0.0244***	-0.328	-0.369*	-0.178	-0.189	-0.211	-0.206
	(0.102)	(0.117)	(0.00425)	(0.00121)	(0.0515)	(0.00686)	(0.255)	(0.207)	(0.124)	(0.125)	(0.177)	(0.134)
Observations	6,523	6,808	6,562	6,784	6,430	6,658	7,813	8,089	43,493	43,572	37,826	37,951
Adjusted R-squared	0.941	0.939	0.942	0.941	0.943	0.942	0.932	0.930	0.908	0.908	0.909	0.905
State control variables	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating labor earnings to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. In columns (1) to (8) labor earnings are measured by item *XLR* from Compustat. In columns (9) to (10), labor earnings were constructed by supplementing Compustat with four-digit industry code, state, and firm size level average annual wage and benefits from County Business Patterns (CBP). In columns (11) to (12), labor earnings were imputed by matching non-disclosing firm to similar disclosing firms from Compustat. Labor earnings are scaled by their sample mean. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. The upper table uses the firm-level controls as in Serfling (2016), while the bottom table uses the controls from Michaels et al. (2019). Table A1 in the Appendix provides variable definitions. Financial constraint$_{t-1}$ is a firm-level measure of the degree of financial constraints at year $t-1$. In columns (1) to (6), Financial constraint$_{t-1}$ is measured by the indexes in Hadlock and Pierce (2010), Kaplan and Zingales (1997), and Whited and Wu (2006). In columns (7) and (8), Financial constraint$_{t-1}$ is an indicator variable set to one if a firm is not paying common dividends in year $t-1$ and zero otherwise. Columns (9) to (12) use the Hadlock and Pierce (2010) index to proxy financial constraints. Odd columns include state-year fixed effects. Even columns include state-level controls. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 9: Financial constraints and firm earnings

	Hadlock and Pierce (2010)		Kaplan and Zingales (1997)		Whithed and Wu (2006)		Non-dividend payer	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	EBIT							
Good faith$_t$	-1.434***	-0.957**	-0.00189	0.201*	-0.0180	0.196*	0.241*	0.455***
	(0.495)	(0.411)	(0.113)	(0.110)	(0.118)	(0.115)	(0.123)	(0.163)
Financial constraint$_{t-1}$	0.0608	0.0804	-0.000102	-1.96e-05	-0.0349	-0.0349	-0.257**	-0.228**
	(0.186)	(0.174)	(0.000191)	(0.000146)	(0.0223)	(0.0220)	(0.100)	(0.0960)
Good faith$_t$ × Financial constraint$_{t-1}$	-0.490***	-0.393***	-0.000168	-8.88e-05	-0.00976	-0.0134	-0.452*	-0.485**
	(0.163)	(0.140)	(0.000102)	(6.43e-05)	(0.0133)	(0.0121)	(0.236)	(0.207)
Observations	75,700	75,753	80,472	80,506	77,983	78,019	89,794	89,852
Adjusted R-squared	0.857	0.854	0.867	0.865	0.867	0.865	0.857	0.855
	EBITDA							
Good faith$_t$	-1.404***	-1.106***	0.0431	0.183**	0.0282	0.180**	0.218**	0.398***
	(0.442)	(0.317)	(0.0731)	(0.0765)	(0.0761)	(0.0802)	(0.0893)	(0.108)
Financial constraint$_{t-1}$	0.248*	0.261**	-3.06e-05	5.94e-05	-0.0158	-0.0160	-0.113**	-0.0958*
	(0.132)	(0.127)	(0.000128)	(8.75e-05)	(0.0129)	(0.0127)	(0.0528)	(0.0524)
Good faith$_t$ × Financial constraint$_{t-1}$	-0.497***	-0.422***	-0.000153*	-8.18e-05	-0.0140*	-0.0161**	-0.360*	-0.395**
	(0.138)	(0.102)	(8.62e-05)	(6.36e-05)	(0.00798)	(0.00704)	(0.193)	(0.162)
Observations	75,681	75,734	80,421	80,455	77,932	77,968	89,737	89,795
Adjusted R-squared	0.887	0.887	0.910	0.910	0.909	0.909	0.890	0.890
State control variables	NO	YES	NO	YES	NO	YES	NO	YES
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating EBIT and EBITDA to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. EBIT and EBITDA are normalized by their sample average. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. The upper table uses EBIT as dependent variable, while the bottom table uses EBITDA. The firm-level controls are the ones used in Serfling (2016). Table A1 in the Appendix provides variable definitions. Financial constraint$_{t-1}$ is a firm-level measure of the degree of financial constraints at year $t-1$. In columns (1) to (6), Financial constraint$_{t-1}$ is measured by the indexes in Hadlock and Pierce (2010), Kaplan and Zingales (1997), and Whited and Wu (2006). In columns (7) and (8), Financial constraint$_{t-1}$ is an indicator variable set to one if a firm is not paying common dividends in year $t-1$ and zero otherwise. Odd columns include state-year fixed effects. Even columns include state-level controls. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 10: Financial constraints, employment and investment

	Log Assets		Hadlock and Pierce (2010)		Kaplan and Zingales (1997)		Whited and Wu (2006)		Non-dividend payer	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
					Employment					
Good faith$_t$	-0.0750	0.0280	-0.728***	-0.617**	0.107	0.154*	0.125	0.166*	0.165	0.244*
	(0.264)	(0.336)	(0.235)	(0.252)	(0.114)	(0.0853)	(0.122)	(0.0832)	(0.138)	(0.134)
Financial constraint$_{t-1}$	0.529***	0.545***	-0.0895	-0.0841	0.000296*	0.000277*	-0.00661	-0.00363	-0.164***	-0.140***
	(0.0613)	(0.0644)	(0.0990)	(0.108)	(0.000166)	(0.000145)	(0.00791)	(0.00781)	(0.0466)	(0.0423)
Good faith$_t$ × Financial constraint$_{t-1}$	0.0388	0.0258	-0.295***	-0.245***	1.95e-06	0.000237*	0.00922	0.0155	-0.101	-0.114
	(0.0630)	(0.0693)	(0.0883)	(0.0912)	(0.000267)	(0.000139)	(0.0162)	(0.0183)	(0.112)	(0.110)
Observations	85,952	86,013	73,411	73,469	78,030	78,059	75,720	75,751	85,952	86,013
Adjusted R-squared	0.895	0.891	0.898	0.893	0.904	0.899	0.905	0.900	0.892	0.887
					Capital expenditures					
Good faith$_t$	-1.050	-0.815	-1.637**	-1.189**	0.0440	0.225***	0.0375	0.228***	0.212**	0.513***
	(0.630)	(0.553)	(0.632)	(0.510)	(0.0670)	(0.0733)	(0.0671)	(0.0730)	(0.0910)	(0.142)
Financial constraint$_{t-1}$	0.487***	0.487***	-0.00679	0.0276	5.25e-05	0.000133	-0.0241	-0.0262	-0.190***	-0.176***
	(0.0774)	(0.0728)	(0.141)	(0.127)	(0.000156)	(0.000153)	(0.0187)	(0.0164)	(0.0617)	(0.0575)
Good faith$_t$ × Financial constraint$_{t-1}$	0.217*	0.206*	-0.584***	-0.473***	-0.000114	-7.23e-05	-0.00675	-0.00680	-0.391*	-0.387*
	(0.110)	(0.106)	(0.203)	(0.168)	(0.000105)	(8.07e-05)	(0.00983)	(0.0111)	(0.224)	(0.202)
Observations	88,691	88,752	75,701	75,754	79,598	79,633	77,143	77,180	88,691	88,752
Adjusted R-squared	0.869	0.869	0.862	0.862	0.887	0.887	0.887	0.886	0.867	0.867
State control variables	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating employment and capital expenditures (investment) to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. Employment and capital expenditures are normalized by their sample average. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. The upper table uses employment as dependent variable, the bottom table uses capital expenditures. The firm-level controls are the ones used in Serfling (2016). Table A1 in the Appendix provides variable definitions. Financial constraint$_{t-1}$ is a firm-level measure of the degree of financial constraints at year $t-1$. In columns (1) and (2), Financial constraint$_{t-1}$ is replaced by firm size (Log of assets). In columns (3) to (8), Financial constraint$_{t-1}$ is measured by the indexes in Hadlock and Pierce (2010), Kaplan and Zingales (1997), and Whited and Wu (2006). In columns (9) and (10), Financial constraint$_{t-1}$ is an indicator variable set to one if a firm is not paying common dividends in year $t-1$ and zero otherwise. Odd columns include state-year fixed effects. Even columns include state-level controls. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table 11: Financial constraints, debt and the cost of debt

	Log Assets		Hadlock and Pierce (2010)		Kaplan and Zingales (1997)		Whited and Wu (2006)		Non-dividend payer	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
					Debt					
Good faith$_t$	-0.322	-0.361	-1.467**	-1.368***	0.106	0.0964	0.0857	0.0872	0.206	0.265**
	(0.343)	(0.261)	(0.548)	(0.388)	(0.0991)	(0.0680)	(0.0933)	(0.0729)	(0.134)	(0.104)
Financial constraint$_{t-1}$	0.414***	0.420***	0.833***	0.781***	-4.61e-05	3.36e-05	0.0261	0.0280	0.107	0.112
	(0.0796)	(0.0763)	(0.296)	(0.282)	(0.000121)	(0.000123)	(0.0216)	(0.0221)	(0.0925)	(0.0895)
Good faith$_t$ × Financial constraint$_{t-1}$	0.0842	0.0869	-0.561***	-0.446***	-6.29e-05	-1.67e-05	-0.0464***	-0.0389***	-0.260**	-0.293***
	(0.0599)	(0.0563)	(0.165)	(0.125)	(0.000148)	(0.000127)	(0.0130)	(0.0128)	(0.119)	(0.102)
Observations	89,905	89,963	75,668	75,721	80,576	80,610	78,079	78,115	89,905	89,963
Adjusted R-squared	0.781	0.782	0.775	0.775	0.808	0.808	0.807	0.807	0.777	0.777
					Cost of debt					
Good faith$_t$	0.745**	0.454***	0.709**	0.441**	0.166	0.0348	0.180	0.0336	0.331	-0.00852
	(0.297)	(0.164)	(0.320)	(0.199)	(0.161)	(0.0604)	(0.178)	(0.0561)	(0.248)	(0.0592)
Financial constraint$_{t-1}$	-0.0170	-0.0234	-0.0795	-0.0765	-0.000436	-0.000425	0.00108**	0.00105**	0.0194	0.0346
	(0.0282)	(0.0291)	(0.0504)	(0.0537)	(0.000276)	(0.000274)	(0.000456)	(0.000437)	(0.0365)	(0.0362)
Good faith$_t$ × Financial constraint$_{t-1}$	-0.0709***	-0.0712***	0.115**	0.114**	0.00108**	0.00105**	0.000497	0.000512	0.126**	0.140**
	(0.0224)	(0.0208)	(0.0503)	(0.0489)	(0.000456)	(0.000437)	(0.000315)	(0.000308)	(0.0612)	(0.0594)
Observations	80,298	80,359	68,018	68,075	72,009	72,045	69,981	70,020	80,298	80,359
Adjusted R-squared	0.271	0.261	0.288	0.277	0.271	0.262	0.275	0.266	0.271	0.261
State control variables	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO

This table presents the results from OLS regressions relating debt and the cost of debt to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. Debt and the cost of debt are normalized by their sample average. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. Dollar values are expressed in 2009 dollars. The upper table uses debt as dependent variable, the bottom table uses the cost of debt. The firm-level controls are the ones used in Serfling (2016). Table A1 in the Appendix provides variable definitions. Financial constraint$_{t-1}$ is a firm-level measure of the degree of financial constraints at year $t-1$. In columns (1) and (2), Financial constraint$_{t-1}$ is replaced by firm size (Log of assets). In columns (3) to (8), Financial constraint$_{t-1}$ is measured by the indexes in Hadlock and Pierce (2010), Kaplan and Zingales (1997), and Whited and Wu (2006). In columns (9) and (10), Financial constraint$_{t-1}$ is an indicator variable set to one if a firm is not paying common dividends in year $t-1$ and zero otherwise. Odd columns include state-year fixed effects. Even columns include state-level controls. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

A Appendix

A.1 The debt contract

In this section, I characterize the optimal debt contract. Define the auxiliary function:

$$\Psi(a, d, l) \equiv \Pi^E(a, d, l) - \phi k, \tag{A.1}$$

which measures the severity of agency problems for a triplet (a, d, l).[17] Analogously as in Fischer and Huerta (2021), it can be shown that there exists a minimum wealth required to obtain a loan, denoted by $\underline{a} > 0$. The following conditions define $\underline{a}$, the amount of debt that such agent can get ($\underline{d}$), and the amount of labor she hires ($\underline{l}$):[18]

$$\Psi(\underline{a}, \underline{d}, \underline{l}) = 0 \Leftrightarrow \Pi^E(\underline{a}, \underline{d}, \underline{l}) = \phi \underline{k} \tag{A.2}$$

$$\Psi_d(\underline{a}, \underline{d}, \underline{l}) = 0 \Leftrightarrow p f_k(\underline{k}, (1-s)\underline{l}) = 1 + \underline{r}, \tag{A.3}$$

$$\frac{\partial \Pi^E(\underline{a}, \underline{d}, \underline{l})}{\partial l} = 0 \Leftrightarrow p(1-s) f_l(\underline{k}, (1-s)\underline{l}) = \bar{w}, \tag{A.4}$$

where $1 + \underline{r} \equiv 1 + r^* + \phi$ and $\underline{k} \equiv \underline{a} + \underline{d}$. Intuitively, the first condition requires that the minimum wealth to get a loan, $\underline{a}$, leaves the agent just indifferent between absconding with the loan or honoring the credit contract. The second condition imposes that an agent with $\underline{a}$ obtains his minimum debt, $\underline{d}$. The final condition asks that the amount of labor hired, $\underline{l}$, is optimal at the capital level $\underline{k}$.

Condition (A.3) implies that the marginal return to investment for the first agent with access to credit is $1 + r^* + \phi$, corresponding to the highest possible return to investment. As a increases, the return to capital falls until it eventually attains the level achieved by an efficient firm, $1 + r^*$. Since Π^E is increasing and continuous in the relevant range, there exists another critical wealth level, $\bar{a} > \underline{a}$, such that an entrepreneur with $\bar{a}$ is the first agent who can obtain a loan to invest efficiently:

$$\Psi(\bar{a}, k^* - \bar{a}, l^*) = 0. \tag{A.5}$$

In equilibrium, these two thresholds define an endogenous range of entrepreneurs, $[\underline{a}, \bar{a})$, who have restricted access to credit and operate at an inefficient scale. Because the marginal return to capital is larger than the marginal cost of debt within this range, constrained agents ask for their

[17] If $\Psi > 0$ the incentives to commit default decrease as Ψ increases. In contrast, if $\Psi < 0$ the entrepreneur has incentives to behave maliciously. A more negative Ψ means that the entrepreneur has less incentives to honor the credit contract and abscond with the loan.

[18] Conditions below arise from a *minimax* problem. See Fischer and Huerta (2021) for more details.

maximum allowable loan, which is given by:

$$\Psi(a, d, l) = 0, \tag{A.6}$$

where labor $l \equiv l(a)$ satisfies,

$$p(1-s) f_l(a + d, (1-s)l) = \bar{w}. \tag{A.7}$$

A.2 Main Proofs

Lemma 1 *Consider a marginal increase in the strength of EPL, then the wage rate w^i goes down. If $i \in (0, 1)$, then the* expected wage *$\bar{w}^i$ increases and the interest rate ρ decreases. If $i = 0$, then $\bar{w}^i$ and ρ remain unchanged.*

Proof: First, differentiate condition (A.2) in terms of the strength of EPL, $x = \{\varphi, \theta\}$:

$$\Psi_a \cdot \underline{a}_x + \underbrace{\Psi_d}_{=0 \text{ by (A.2)}} \underline{d}_x + \underbrace{\Psi_l}_{=0 \text{ by (A.4)}} \underline{l}_x + \Psi_{\bar{w}} \bar{w}^i_x + \Psi_\rho \rho_x = 0 \Rightarrow \underline{a}_x = \frac{\bar{w}^i_x \, \underline{l} + \rho_x \, \underline{d}}{p f_k(\underline{k}, \underline{l}) + (1-p)\eta - \phi}, \tag{A.8}$$

where the operator $(\cdot)_z$ denotes the derivative in terms of a variable z. A similar approach shows that:

$$d_x = \frac{\bar{w}^i_x \, l + \rho_x \, d}{p f_k(k, l) - (1 + \underline{r})}. \tag{A.9}$$

Differentiation of condition (2.10) in terms of x gives:

$$\begin{aligned} &\int_{\underline{a}}^{a^M} d_x \; g(a) \partial a = \underline{k} \; g(\underline{a}) \; \underline{a}_x, \\ \Leftrightarrow &\int_{\underline{a}}^{a^M} \frac{\bar{w}^i_x \, l + \rho_x \, d}{p f_k(k, l) - (1 + \underline{r})} \; g(a) \partial a = \underline{k} \; g(\underline{a}) \; \frac{\bar{w}^i_x \, \underline{l} + \rho_x \, \underline{d}}{p f_k + (1-p)\eta - \phi} \end{aligned} \tag{A.10}$$

Rearranging terms:

$$\bar{w}^i_x \underbrace{\left(\int_{\underline{a}}^{a^M} \frac{l}{p f_k(k, l) - (1 + \underline{r})} \, g(a) \partial a - \frac{\underline{k} \underline{l} g(\underline{a})}{p f_k(\underline{k}, \underline{l}) + (1-p)\eta - \phi} \right)}_{>0} = \rho_x \underbrace{\left(\int_{\underline{a}}^{a^M} \frac{d}{p f_k(k, l) - (1 + \underline{r})} \, g(a) \partial a + \frac{\underline{k} \underline{d} g(\underline{a})}{p f_k(\underline{k}, \underline{l}) + (1-p)\eta - \phi} \right)}_{<0}, \tag{A.11}$$

where I have used that $p f_k \in [1 + \rho - (1-p)\eta, 1 + \rho - (1-p)\eta + \phi]$ with $p f_k$ decreasing in k. Condition (A.11) implies that, if $i = 0$ (i.e. the wage rate is fully flexible), it must be that $\bar{w}^i_x = 0$

and $\rho_x = 0$. Additionally, note that:

$$\bar{w}_x^i = \begin{cases} psw^i + [p(1-s+s\varphi) + (1-p)\theta]w_\varphi^i & \text{if } x = \varphi, \\ (1-p)w^i + [p(1-s+s\varphi) + (1-p)\theta]w_\theta^i & \text{if } x = \theta. \end{cases} \tag{A.12}$$

If $i = 0$, then $\bar{w}_x^i = 0$ and so $w_\varphi^i = \frac{-psw^i}{p(1-s+s\varphi)+(1-p)\theta} < 0$ and $w_\theta^i = \frac{(1-p)w^i}{p(1-s+s\varphi)+(1-p)\theta} < 0$. If $i > 0$, then $\bar{w}_x^i > 0$, and thus, $\rho_x < 0$ by condition (A.11). ■

Proposition 1 *Consider a marginal improvement of EPL. Then, there are two critical wealth thresholds $a^L > \underline{a}$ and $a^H > a^L$ such that:*

1. *Π^E decreases for firms with $a \in [\underline{a}, a^L]$.*
2. *Π^E increases for firms with $a \in [a^H, \bar{a}]$.*

Proof: To simplify calculations, define $x = \{\varphi, \theta\}$. Differentiation of Π^E in terms of x gives:

$$\begin{aligned} \Pi_x^E &= [pf_k(k,l) - (1+r^*)]d_x - \bar{w}_x^i l - \rho_x d \\ &= [pf_k(k,l) - (1+r^*)]\frac{\bar{w}_x^i\, l + \rho_x\, d}{pf_k(k,l) - (1+\underline{r})} - \bar{w}_x^i l - \rho_x d \\ &= \phi\frac{\bar{w}_x^i\, l + \rho_x\, d}{pf_k(k,l) - (1+\underline{r})}. \end{aligned} \tag{A.13}$$

Note that the minimum collateral increases when EPL improves ($\underline{a}_x > 0$). Therefore, equation (A.8) implies that $\bar{w}_x^i\, \underline{l} + \rho_x\, \underline{d} > 0$, and thus, $\lim_{a \to \underline{a}+} \Pi_x^E = -\infty$. By the continuity of Π_x^E in a, there is a range of "low" assets entrepreneurs, $[\underline{a}, a^L]$, who are made worse off when x increases ($\Pi_x^E < 0$). Additionally, for condition (A.10) to hold, it must be that $\bar{w}_x^i\, l + \rho_x\, d < 0$ for a range of wealthier agents, $a \in [a^H, \bar{a}]$. Thus, $\Pi_x^E > 0$ in that range. ■

Proposition 2 *Consider a marginal improvement of EPL. Then, there are two critical wealth thresholds $\tilde{a}^L > \underline{a}$ and $\tilde{a}^H > \tilde{a}^L$ such that:*

1. *Π^W decreases for workers in firms with $a \in [\underline{a}, \tilde{a}^L]$.*
2. *Π^W increases for workers in firms with $a \in [\tilde{a}^H, \bar{a}]$.*

Proof: Differentiating condition (2.3) with respect to $x = \{\varphi, \theta\}$:

$$\Pi_x^W = \bar{w}_x^i \cdot l + \bar{w}^i \cdot l_x. \tag{A.14}$$

To obtain an expression for l_x differentiate (A.7) in terms of x:

$$
\begin{aligned}
p(1-s)[f_{kl}(k,l)d_x + (1-s)f_{ll}(k,l)l_x] &= \bar{w}^i_x \\
\Rightarrow l_x &= \frac{\bar{w}^i_x}{p(1-s)^2 f_{ll}} - \frac{f_{lk}(k,l)}{(1-s)f_{ll}(k,l)} d_x,
\end{aligned}
\tag{A.15}
$$

Replacing in equation (A.14) gives:

$$
\Pi^W_x = \bar{w}^i_x \left(l + \frac{\bar{w}^i}{p(1-s)^2 f_{ll}} \right) - \bar{w}^i \frac{f_{lk}(k,l)}{(1-s)f_{ll}(k,l)} d_x. \tag{A.16}
$$

Note that the sign of Π^W_x is ambiguous and depends on a. For a firm operating close enough to $\underline{a}$, $\lim_{a\to\underline{a}^+} \Pi^W = -\infty$ (since $\lim_{a\to\underline{a}^+} d_x = -\infty$). By the continuity of Π^W in a, there is a range of firms with assets in $[\underline{a}, \tilde{a}^L]$ such that $\Pi^W_x < 0$.

The labor market condition under wage inflexibility reads as:

$$
G(\underline{a}) + u = \int_{\underline{a}}^{a^M} l \; g(a)\partial a, \tag{A.17}
$$

where u is the fraction of unemployed agents. If $i = 0$, then $u = 0$. Otherwise, $u > 0$. Note that when x goes up, u has to increase to account for the fact that the wage rate does not fully adjust (i.e. $u_x > 0$). This condition implies the following labor earnings' equivalence condition:

$$
[G(\underline{a}) + u]\bar{w}^i = \int_{\underline{a}}^{a^M} \Pi^W g(a)\partial a. \tag{A.18}
$$

Differentiating (A.18) in terms of x gives:

$$
\bar{w}^i \underbrace{[g(\underline{a})\underline{a}_x + u_x]}_{>0} + \underbrace{\bar{w}^i_x}_{>0}[G(\underline{a}) + u] = \int_{\underline{a}}^{a^M} \Pi^W_x g(a)\partial a. \tag{A.19}
$$

The left-hand of (A.19) is positive, and also $\Pi^W_x < 0$ for $a \in [\underline{a}, \tilde{a}^L]$. Thus, in order to satisfy this condition it must be that $\Pi^W_x > 0$ in some range of wealthier entrepreneurs $a \in [\tilde{a}^H, \overline{a}]$. ■

A.3 Additional tables

Table A1: Variable definitions

Variable	**Description (Compustat variable names in parentheses where appropriate)**
Dependent variables	
Labor earnings (Compustat)	Salaries, wages, pension costs, profit sharing and incentive compensation, payroll taxes and other employee benefits (XLR)
Labor earnings (CBP-Supplemented)	Average wages and benefits at the four-digit SIC industry, state, and firm size level (CBP), times firm employment from Compustat (item *EMP*)
Labor earnings (Matching Imputation)	Imputed wage and benefits by matching non-disclosing with disclosing Compustat firms, times firm employment from Compustat (item *EMP*)
Employment	Number of company workers (EMP)
EBIT	Earnings before interest and taxes (EBIT)
EBITDA	Earnings before interest (EBITDA)
Capital expenditures	Cash outflow or the funds used for additions to the company's property, plant and equipment, excluding amounts arising from acquisitions (CAPX)
Debt	Long-term debt (DLTT) plus debt in current liabilities (DLC)
Cost of debt	Total interest and related expenses (XINT) divided by book value of long-term debt (DLTT) plus debt in current liabilities (DLC)
Control variables	
Good faith	An indicator variable set to one if the state in which the firm is headquartered adopted the good faith exception
Implied contract	An indicator variable set to one if the state in which the firm is headquartered adopted the implied contract exception
Public policy	An indicator variable set to one if the state in which the firm is headquartered adopted the public policy exception
Assets	Total value of book assets (AT)
Profitability	Income before extraordinary items (IB) plus deprecaition and amortization (DP) divided by the book value of assets (AT)
Fixed assets	Property, plant and equipment (PPENT) divided by the book value of assets (AT)
Market to book	The market value of assets (AT+PRCC_F*CSHO-CEQ) divided by the book value of assets (AT)
Dividend payer	An indicator variable set to one if the firm pays a common dividend (DVC)
Modified z-score	The modified Altman's z-score (1.2*WCAP+1.4*RE+3.3*EBIT+SALE)/AT
Sales	Gross sales (SALE)
Book leverage	Book value of long-term debt (DLTT) plus debt in current liabilities (DLC) divided by book value of assets (AT)
State per capita GDP	State's GDP divided by its total population
State GDP growth	State-level GDP growth
Circuit good faith	Fraction of other states in the same federal circuit as the firm's headquarter state that have adopted the good faith exception.
Right-to-work	An indicator variable set to one if the state in which the firm is headquartered has adopted the right-to-work laws
Union membership	Fraction of employees who are covered by collective bargaining agreements in a given state
Political balance	Fraction of Democrat state representatives in the House of Representatives and Senate

Table A2: The good faith exception and the timing of labor and firm earnings

	Labor earnings								EBIT			
	Compustat				CBP-Supplemented		Matching Imputation					
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
									Restricted sample		Full sample	
Good faith^{-1}	-0.519	-0.495	-0.243	-0.377	0.101	0.0343	-0.460	-0.540*	-3.920	-2.484	-1.490	-1.441
	(0.588)	(0.468)	(0.439)	(0.392)	(0.364)	(0.398)	(0.278)	(0.322)	(5.306)	(4.340)	(1.017)	(0.883)
Good faith^{0}	-1.267	-1.107**	-0.101	-0.806**	-0.239	-0.268	-0.629*	-0.737**	-15.78*	-8.183	-2.006	-1.935*
	(0.943)	(0.487)	(0.504)	(0.349)	(0.358)	(0.365)	(0.313)	(0.292)	(8.831)	(5.652)	(1.241)	(1.069)
Good faith^{+1}	-0.971	-1.109**	0.821	-0.399	0.0253	0.0337	-0.319	-0.258	-20.99**	-10.54*	-1.374	-1.320
	(1.102)	(0.479)	(0.571)	(0.366)	(0.273)	(0.286)	(0.263)	(0.269)	(9.837)	(6.101)	(1.160)	(0.873)
Good faith^{+2}	-0.467	-0.980*	1.579***	-0.262	-0.273	-0.272	-0.619*	-0.623	-21.56*	-11.00	-1.057	-1.017*
	(1.023)	(0.521)	(0.531)	(0.437)	(0.272)	(0.284)	(0.368)	(0.386)	(11.00)	(7.049)	(0.948)	(0.605)
Good faith^{-1} × Log Assets$_{t-1}$	0.127	0.0777	0.0839	0.0686	-0.0142	-0.00112	0.0982	0.110*	0.294	0.373	0.324*	0.297*
	(0.0818)	(0.0716)	(0.0668)	(0.0641)	(0.0701)	(0.0756)	(0.0586)	(0.0644)	(1.103)	(0.806)	(0.181)	(0.172)
Good faith^{0} × Log Assets$_{t-1}$	0.301***	0.190**	0.173***	0.167**	0.0588	0.0666	0.116**	0.130**	1.632	1.329	0.448**	0.413*
	(0.0901)	(0.0783)	(0.0634)	(0.0674)	(0.0726)	(0.0753)	(0.0555)	(0.0506)	(1.472)	(0.952)	(0.217)	(0.211)
Good faith^{+1} × Log Assets$_{t-1}$	0.261**	0.176**	0.121	0.101	0.00952	0.0102	0.0705	0.0592	2.324*	1.742*	0.314*	0.282*
	(0.115)	(0.0870)	(0.0752)	(0.0749)	(0.0587)	(0.0616)	(0.0459)	(0.0452)	(1.283)	(0.900)	(0.172)	(0.166)
Good faith^{+2} × Log Assets$_{t-1}$	0.219*	0.163*	0.0455	0.0634	0.0997*	0.103*	0.132**	0.131**	2.358*	1.869*	0.240**	0.226**
	(0.112)	(0.0842)	(0.0759)	(0.0816)	(0.0582)	(0.0610)	(0.0599)	(0.0625)	(1.206)	(0.973)	(0.114)	(0.107)
Observations	8,344	8,561	9,755	9,958	48,951	47,080	46,364	44,073	8,344	8,561	89,230	89,288
Adjusted R-squared	0.931	0.930	0.928	0.927	0.906	0.907	0.859	0.863	0.848	0.851	0.828	0.828
Controls												
Serfling (2016)	YES	YES	NO	NO	YES	NO	YES	NO	YES	YES	YES	YES
Michaels et al. (2019)	NO	NO	YES	YES	NO	YES	NO	YES	NO	NO	NO	NO
State control variables	NO	YES	NO	YES	YES	YES	YES	YES	NO	YES	NO	YES
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State x Year fixed effects	YES	NO	YES	NO	NO	NO	NO	NO	NO	YES	NO	YES

This table presents the results from OLS regressions relating labor and firm earnings to the *good faith exception* adoption for Compustat non-financial firms from 1967 to 1995. In columns (1) to (4), labor earnings are measured by item *XLR* from Compustat. In columns (5) and (6), labor earnings were constructed by supplementing Compustat with average annual wage and benefits data at the four-digit industry code, state, and firm size level from County Business Patterns (CBP). In columns (7) and (8), labor earnings are imputed by matching non-disclosing firms to similar disclosing firms from Compustat. EBIT is earnings before interest and taxes. Labor earnings and EBIT were scaled by their sample mean. Good faith^{-1} is an indicator variable set to one if the state at which a firm is headquartered will adopt the *good faith exception* in one year and zero otherwise. Good faith^{0} is an indicator variable set to one if the state at which a firm is headquartered adopts the exception in the current year and zero otherwise. Good faith^{+1} is an indicator variable set to one if the state at which a firm is headquartered adopted the exception one year ago and zero otherwise. Good faith^{+2} is an indicator variable set to one if the state at which a firm is headquartered adopted the exception two years or more years ago and zero otherwise. Dollar values are expressed in 2009 dollars. Table A1 provides variable definitions. Columns (1)-(2), (5), (7), and (9)-(12) use the control variables from Serfling (2016), columns (3)-(4), (6) and (8) use the controls from Michaels et al. (2019). All regressions include firm fixed effects, state-level fixed effects, and industry-year fixed effects. Columns (1), (3), (10) and (12) include state-year fixed effects instead of state-level control variables. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table A3: Controlling for political factors

	Compustat		Labor earnings CBP-Supplemented		Matching Imputation		EBIT	EBITDA	Employment	Cap. Expenditures	Debt	Cost of debt
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
						Log Assets						
Good faith$_t$	-0.718*	-0.832*	-0.312	-0.309	-0.428	-0.437	-0.877	-0.761*	0.0635	-0.689	-0.301	0.472***
	(0.359)	(0.426)	(0.227)	(0.239)	(0.277)	(0.278)	(0.428)	(0.257)	(0.536)	(0.428)	(0.247)	(0.169)
Log Assets$_{t-1}$	0.482***	0.137	0.507***	0.171**	0.400***	0.0952**	0.551***	0.442***	0.520***	0.486***	0.437***	-0.0183
	(0.0959)	(0.108)	(0.0699)	(0.0689)	(0.0406)	(0.0356)	(0.105)	(0.0715)	(0.116)	(0.0705)	(0.0770)	(0.0302)
Good faith$_t$ × Log Assets$_{t-1}$	0.123*	0.140**	0.0879*	0.0903	0.0877*	0.0885*	0.201*	0.175**	0.0203	0.179*	0.0758	-0.0746***
	(0.0621)	(0.0684)	(0.0513)	(0.0540)	(0.0478)	(0.0479)	(0.0967)	(0.0628)	(0.101)	(0.0788)	(0.0535)	(0.0222)
Union Membership$_t$	0.0232*	0.0236*	0.00305	0.00212	0.196	0.169	-0.00647	-0.00394	-0.00535	-0.0146	-0.00345	-0.00217
	(0.0127)	(0.0139)	(0.0160)	(0.0156)	(0.207)	(0.214)	(0.0114)	(0.0105)	(0.0132)	(0.0155)	(0.00795)	(0.00612)
Right-to-work$_t$	-0.154	0.248**	0.0766	0.150	-0.0333	-0.0281	0.197	0.113	0.261	0.270*	-0.666***	0.687***
	(0.184)	(0.0936)	(0.124)	(0.189)	(0.0385)	(0.0390)	(0.168)	(0.135)	(0.281)	(0.153)	(0.208)	(0.154)
Political balance$_t$	-0.0941	-0.0246	-0.107	-0.100	-0.0324	-0.0419	-0.451	-0.288	-0.0424	-0.319	0.424	0.150
	(0.250)	(0.243)	(0.179)	(0.178)	(0.149)	(0.159)	(0.386)	(0.286)	(0.236)	(0.328)	(0.322)	(0.189)
Observations	8,030	7,548	49,063	47,194	44,514	42,494	86,833	86,777	83,511	85,881	86,944	77,709
Adjusted R-squared	0.935	0.936	0.906	0.907	0.861	0.863	0.829	0.894	0.872	0.870	0.783	0.103
						SA Index (Hadlock and Pierce, 2010)						
Good faith$_t$	-0.832	-0.782	-0.662	-0.483	-0.503	-0.626	-0.983**	-1.122***	-0.619**	-1.207**	-1.353***	0.447**
	(0.506)	(0.484)	(0.411)	(0.370)	(0.517)	(0.465)	(0.422)	(0.322)	(0.255)	(0.515)	(0.391)	(0.202)
SA Index$_{t-1}$	0.561***	1.202***	-0.142	1.136***	-0.184	0.924***	0.0881	0.271**	-0.0758	0.0333	0.806***	-0.0775
	(0.116)	(0.275)	(0.128)	(0.209)	(0.124)	(0.140)	(0.177)	(0.129)	(0.109)	(0.130)	(0.280)	(0.0542)
Good faith$_t$ × SA index$_{t-1}$	-0.269*	-0.265*	-0.250*	-0.203	-0.174	-0.209	-0.406***	-0.430***	-0.245**	-0.482***	-0.438***	0.116**
	(0.159)	(0.149)	(0.138)	(0.124)	(0.147)	(0.132)	(0.145)	(0.106)	(0.0931)	(0.170)	(0.124)	(0.0487)
Union Membership$_t$	0.0209*	0.0211	0.0132	-0.0125	0.135**	0.0938	-0.0107	-0.00700	-0.00736	-0.0154	0.00190	-0.00530
	(0.0120)	(0.0130)	(0.102)	(0.114)	(0.0662)	(0.0609)	(0.0135)	(0.0123)	(0.0148)	(0.0175)	(0.00764)	(0.00636)
Right-to-work$_t$	0.368***	0.185**	0.231**	0.240**	0.0229	0.0122	0.241	0.156	0.432	0.254	-0.442**	0.781***
	(0.124)	(0.0878)	(0.102)	(0.105)	(0.0432)	(0.0419)	(0.192)	(0.154)	(0.310)	(0.175)	(0.211)	(0.184)
Political balance$_t$	-0.0390	-0.0210	-1.545	1.824*	-0.823	1.703**	-0.691	-0.418	-0.00254	-0.377	0.591	0.0591
	(0.254)	(0.218)	(1.218)	(1.076)	(0.682)	(0.689)	(0.459)	(0.335)	(0.266)	(0.380)	(0.426)	(0.182)
Observations	6,993	6,772	43,646	42,868	38,851	37,783	75,626	75,607	73,346	75,627	75,594	67,951
Adjusted R-squared	0.930	0.940	0.905	0.910	0.863	0.874	0.823	0.887	0.870	0.861	0.775	0.114
Controls												
Serfling (2016)	YES	NO	YES	NO	YES	NO	YES	YES	YES	YES	YES	YES
Michaels et al. (2019)	NO	YES	NO	YES	NO	YES	NO	NO	NO	NO	NO	NO
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES

This table presents the results from OLS regressions relating labor earnings, EBIT, EBITDA, employment, capital expenditures, debt, and the cost of debt to the adoption of the *good faith exception* for Compustat non-financial firms from 1967 to 1995. All variables are normalized by their sample means. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. In columns (1) and (2), labor earnings correspond to item *XLR* from Compustat. In columns (3) and (4), labor earnings are constructed by supplementing Compustat with average annual wage and benefits data at the four-digit industry code, state, and firm size level from County Business Patterns (CBP). In columns (5) and (6), labor earnings are imputed by matching non-disclosing firms to similar disclosing firms from Compustat. Table A1 provides variable definitions. All regressions include firm fixed effects, state-level fixed effects, and industry-year fixed effects. The firm and state-level controls used in Tables 5 and 7 are included in all regressions. The upper table interacts Good faith$_t$ with the lagged Log of assets, while the bottom table uses the SA index introduced by Hadlock and Pierce (2010). Three additional state-level controls are included. (1) Union membership$_t$: the fraction of employees who are covered by collective bargaining agreements at year t. (2) Right-to-work$_t$: an indicator variable set to one if the state in which the firm is headquartered has passed the right-to-work laws by year t. (3) Political balance$_t$: the fraction of Democrat state representatives in the House of Representatives and Senate. Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table A4: Alternative headquarters locations

	Labor earnings						EBIT	EBITDA	Employment	Cap. Expenditures	Debt	Cost of debt
	Compustat		CBP-Supplemented		Matching Imputation							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
							Log Assets					
Good faith$_t$	-0.480	-0.518	-0.393	-0.387	-0.688**	-0.748**	-0.782	-0.823	-0.212	-0.827	-0.699**	0.526**
	(0.346)	(0.383)	(0.325)	(0.336)	(0.294)	(0.309)	(0.562)	(0.510)	(0.312)	(0.512)	(0.333)	(0.211)
Log Assets$_{t-1}$	0.460***	0.0997	0.502***	0.114**	0.469***	0.0949**	0.543***	0.450***	0.534***	0.504***	0.366***	-0.0539
	(0.107)	(0.114)	(0.0754)	(0.0553)	(0.0553)	(0.0366)	(0.115)	(0.0870)	(0.0796)	(0.105)	(0.0843)	(0.0340)
Good faith$_t$ × Log Assets$_{t-1}$	0.0806	0.0862	0.0892	0.0905	0.117**	0.126**	0.187*	0.180*	0.0405	0.181*	0.124*	-0.0749**
	(0.0610)	(0.0654)	(0.0709)	(0.0722)	(0.0544)	(0.0568)	(0.110)	(0.0965)	(0.0645)	(0.0940)	(0.0686)	(0.0304)
Observations	6,341	6,186	39,796	39,282	34,795	34,071	66,805	66,789	65,179	66,806	66,782	60,401
Adjusted R-squared	0.943	0.944	0.911	0.912	0.872	0.874	0.835	0.905	0.880	0.882	0.812	0.0878
							SA Index (Hadlock and Pierce, 2010)					
Good faith$_t$	-0.663	-0.668	-0.500	-0.330	-0.455	-0.614	-0.712	-0.871**	-0.551*	-1.012**	-1.207***	0.507**
	(0.438)	(0.463)	(0.362)	(0.352)	(0.474)	(0.485)	(0.461)	(0.381)	(0.278)	(0.394)	(0.380)	(0.222)
SA Index$_{t-1}$	0.422***	0.887***	-0.114	0.910***	-0.203*	0.892***	0.0703	0.214***	-0.0624	0.0316	0.662**	-0.0525
	(0.0837)	(0.233)	(0.106)	(0.171)	(0.113)	(0.116)	(0.116)	(0.0742)	(0.0850)	(0.132)	(0.295)	(0.0639)
Good faith$_t$ × SA index$_{t-1}$	-0.210	-0.213	-0.195	-0.147	-0.154	-0.195	-0.314*	-0.333**	-0.177*	-0.380***	-0.363***	0.114*
	(0.142)	(0.142)	(0.130)	(0.125)	(0.145)	(0.145)	(0.162)	(0.130)	(0.0987)	(0.126)	(0.130)	(0.0629)
Observations	7,026	6,808	43,886	43,096	38,940	37,868	75,753	75,734	73,469	75,754	75,721	68,080
Adjusted R-squared	0.957	0.962	0.906	0.911	0.865	0.876	0.855	0.907	0.893	0.886	0.776	0.262
Controls												
Serfling (2016)	YES	NO	YES	NO	YES	NO	YES	YES	YES	YES	YES	YES
Michaels et al. (2019)	NO	YES	NO	YES	NO	YES	NO	NO	NO	NO	NO	NO
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES

This table presents the results from OLS regressions relating labor earnings, EBIT, EBITDA, employment, capital expenditures, debt and the cost of debt to the *good faith exception* adoption from Compustat non-financial firms from 1967 to 1995. All variables are normalized by their sample means. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception*n by year t and zero otherwise. The Compustat data on headquarters locations is supplemented by data on historical headquarters locations constructed by Bai et al. (2020). In columns (1) and (2), labor earnings correspond to item *XLR* from Compustat. In columns (3) and (4), labor earnings were constructed by supplementing Compustat with average annual wage and benefits data at the four-digit industry code, state, and firm size level from County Business Patterns (CBP). In columns (5) and (6), labor earnings were imputed by matching non-disclosing firms to similar disclosing firms from Compustat. Table A1 provides variable definitions. All regressions include firm fixed effects, state-level fixed effects, industry-year fixed effects. The firm and state-level controls used in Tables 5 and 7 are included in all regressions. The upper table interacts Good faith$_t$ with the lagged Log of assets, while the bottom table uses the SA index introduced by Hadlock and Pierce (2010). Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.

Table A5: Propensity score matched samples

	Labor earnings						EBIT	EBITDA	Employment	Cap. Expenditures	Debt	Cost of debt
	Compustat		CBP-Supplemented		Matching Imputation							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
							Log Assets					
Good faith$_t$	-0.966*	-1.008**	-0.481*	-0.530*	-0.905***	-0.991**	-1.082*	-0.996*	-0.249	-1.054	-0.558*	0.467**
	(0.498)	(0.495)	(0.269)	(0.287)	(0.337)	(0.375)	(0.575)	(0.502)	(0.307)	(0.666)	(0.328)	(0.198)
Log Assets$_{t-1}$	0.510***	0.121	0.522***	0.164**	0.417***	0.0854**	0.525***	0.429***	0.549***	0.489***	0.451***	-0.0329
	(0.101)	(0.116)	(0.0709)	(0.0698)	(0.0395)	(0.0371)	(0.0967)	(0.0598)	(0.0593)	(0.0717)	(0.0736)	(0.0237)
Good faith × Log Assets$_{t-1}$	0.170*	0.170*	0.122**	0.133**	0.173***	0.190***	0.237**	0.219**	0.0765	0.251*	0.122*	-0.0697**
	(0.0899)	(0.0859)	(0.0582)	(0.0608)	(0.0558)	(0.0628)	(0.108)	(0.0912)	(0.0628)	(0.127)	(0.0676)	(0.0260)
Observations	8,111	7,630	45,454	43,660	45,875	43,569	86,348	86,212	82,441	85,162	86,524	77,303
Adjusted R-squared	0.929	0.930	0.905	0.906	0.859	0.862	0.828	0.891	0.868	0.869	0.782	0.0931
						SA Index (Hadlock and Pierce, 2010)						
Good faith$_t$	-1.145	-0.654	-0.145	1.187***	-0.209*	0.882***	-1.052**	-1.191***	-0.714***	-1.284**	-1.499***	0.412
	(0.751)	(0.515)	(0.135)	(0.215)	(0.123)	(0.139)	(0.434)	(0.366)	(0.233)	(0.598)	(0.452)	(0.254)
SA Index$_{t-1}$	0.450**	1.057***	-0.278*	-0.167	-0.381**	-0.391**	0.0922	0.274**	-0.0705	0.0405	0.788**	-0.0708
	(0.181)	(0.357)	(0.157)	(0.133)	(0.168)	(0.169)	(0.180)	(0.133)	(0.112)	(0.133)	(0.294)	(0.0561)
Good faith$_t$ × SA index$_{t-1}$	-0.370	-0.236	0.00876	-0.0153	0.141**	0.101	-0.425***	-0.454***	-0.278***	-0.507**	-0.486***	0.0985
	(0.237)	(0.168)	(0.107)	(0.120)	(0.0673)	(0.0625)	(0.147)	(0.117)	(0.0840)	(0.198)	(0.143)	(0.0628)
Observations	8,111	7,630	40,363	39,093	38,255	37,149	86,348	86,212	82,441	85,162	72,737	65,431
Adjusted R-squared	0.954	0.954	0.904	0.908	0.863	0.873	0.856	0.909	0.891	0.891	0.774	0.275
Controls												
Serfling (2016)	YES	NO	YES	NO	YES	NO	YES	YES	YES	YES	YES	YES
Michaels et al. (2019)	NO	YES	NO	YES	NO	YES	NO	NO	NO	NO	NO	NO
Firm fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
State fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry x Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES

This table presents the results from OLS regressions relating labor earnings, EBIT, EBITDA, employment, capital expenditures, debt and the cost of debt to the *good faith exception* adoption by using a matched sample from Compustat non-financial firms from 1967 to 1995. All these variables are normalized by their sample means. Propensity scores are estimated based on Log assets, Profitability, Fixed assets, Market to book, Dividend payer, the Modified z-score, and Book leverage. Each treatment firm is matched to a control firm with replacement on year, three-digit SIC industry, and based on the closest propensity score. Good faith$_t$ is an indicator variable set to one if the state at which a firm is headquartered has enacted the *good faith exception* by year t and zero otherwise. In columns (1) and (2), labor earnings correspond to item *XLR* from Compustat. In columns (3) and (4), labor earnings are constructed by supplementing Compustat with average annual wage and benefits data at the four-digit industry code, state, and firm size level from County Business Patterns (CBP). In columns (5) and (6), labor earnings are imputed by matching non-disclosing firms to similar disclosing firms from Compustat. Table A1 provides variable definitions. All regressions include firm fixed effects, state-level fixed effects, and industry-year fixed effects. The firm and state-level controls used in Tables 5 and 7 are included in all regressions. The upper table interacts Good faith$_t$ with the lagged Log of assets, while the bottom table uses the SA index introduced by Hadlock and Pierce (2010). Standard errors are clustered at the state-level (standard deviations in parenthesis). *, **, and *** correspond to significance at the 10%, 5%, and 1% levels, respectively.