Discussion of “CEO Contractual Protection and Debt Contracting”

Xiumin Martin
Summary

• Research question:
  • Do CEO employment contracts affect debt contracting?

• Findings:
  • The presence of CEO contract protection and severance pay is associated with more frequent use of financial covenants, and higher cost of debt.
  • The above association is stronger for CEOs with longer tenure and older CEOs.
  • The above association is stronger for firms with higher growth.
Summary

• The research question is interesting.
• Empirical analyses are comprehensive and thorough.
• Some suggestions on
  • Motivation
  • Hypothesis
  • Empirical tests
Motivation

• Does this study want to shed light on the effect of CEO employment agreements on CEO risk taking?

Or

• how CEO risk preference affect debt contracting?

Or

• the accounting angel?
Motivation

• Does this study want to shed light on the effect of CEO employment agreements on CEO risk taking?

What do we know?

• CEO employment agreements increase CEO risk taking (Huang 2011; Xu 2011; and among others).
Motivation

• Does this study want to shed light on how CEO risk preference affect debt contracting?

What do we know?

• Higher risk taking is associated with higher cost of debt (Bagnani et al. 1994; Ortiz-Molina 2006; Gong et al. 2015);
• Higher risk taking is associated with shorter debt maturity (Brockman et al. 2013);
• Higher risk taking is associated with more covenant usage (Begley and Feltham 1999; Gong et al. 2015)
Motivation - suggestions

• Clearly lay out the motivation in the first two paragraphs of the introduction.
• Both equity incentives such as stock options and contractual protection increase the convexity of the call option, thus increasing risk preference.

Suggestion: will stock options and contractual protection reinforce each other increasing the convexity of the call option value – an interaction effect?
Empirical predictions – risk perspective

• What determines whether there is an explicit employment contract?
  • From the agent perspective:
    • Risk averse
    • Uncertainty
    • Potential loss to CEOs
  • From the principle perspective:
    • Risk neutral
    • Maximizing shareholder value
  • Principle can either pay a premium now or offer an EA to the agent.
    • Because of differences in risk preference, uncertainty or potential loss to CEOs across firms, some agents choose an EA while others do not.
    • In equilibrium, firms with higher uncertainty or higher potential loss to CEOs will likely use EA.

In sum, EA is a way to incentivize CEOs to achieve the optional risk level.
Empirical predictions-risk perspective

• I don’t see why the optimal risk that maximizes shareholder value will depend on the presence of an EA in equilibrium.
• What we observe is: Risky firms likely employ EAs and these firms have higher cost of debt and more covenant protections in debt contracts.

Suggestion:
• It needs an element that there is friction for optional contracting (i.e., cost of having an EA).
• Or EA might induce excessive risk seeking (suboptimal contracting)
Empirical predictions - managerial myopia and accounting quality

• The argument is that EAs reduce managerial myopia.
• Empirically Chen et al. (2015) find that firms with EAs have lower REM (Real Earnings Management)

Questions:
• How about accruals-based earnings management?
• Conceptually does REM reduce accounting information quality?
• Cutting R&D might reduce firm risk, which likely benefit debtholders.
Empirical predictions- real earnings management perspective

- If REM is costly, it is true for both shareholders and debtholders,
- Then firms with an EA, which has lower REM, should have lower interest rates, particularly for longer maturity debt.
Empirical predictions

- In sum, I am unclear regarding the empirical predictions from accounting information perspective.
- From risk perspective, it needs some element of frictions in the equilibrium test or some off-equilibrium analysis.
Empirical predictions- debt maturity structure

• Why focus on financial covenants and loan spread?
  • Should loan maturity structure also be considered?

• Loan maturity seems to be pertinent when we consider horizon.

• **Prediction:**
  • If an EA exacerbates asset substitution risk, then debtholders are expected to shorten debt maturity.
Empirical predictions - covenants

- Why focuses on financial covenants?
  - Should any covenant protect lenders?
- See Billett, King and Maurer (2005).
- Prediction:
  - If an EA exacerbates asset substitution risk, then debtholders are expected to use more covenants.
Empirical predictions - performance pricing

• Why focuses on performance pricing?
• What determines the use of performance pricing?
  • Renegotiation costs (Asquith et al. 2005)
  • Uncertainty (Roberts 2015)

• Type of performance pricing
  • Based on financial variables such as leverage or EBITA;
  • Or debt ratings.
Empirical analyses- cross-sectional analyses

• Use IV approach to estimate the model.
• Include the main effect of the cross-sectional variable (Table 6).
• Some questions on the coefficient estimate on the cross-sectional variable (Table 8):
  • The coefficient on Old_CEO or long tenure is not loaded.
  • The coefficient on growth_stage is negative in the loan spread regression, suggesting that debt holders perceive these firms to have low risk.
Empirical analyses

• Excellent empirical work
• Very comprehensive
Empirical analyses - simultaneity

• Loan contract terms are simultaneously determined.
• It is necessary to estimate loan covenants, interest spread, and debt maturity simultaneously.
Suggestions – Empirical analysis

• IV approach
  • Related with Chen et al. (2015), I am not sure why the effect of non-compete enforceability is negatively associated with CEO protection. I thought it will be the opposite!
  • Needs a more detailed discussion the exclusion restriction condition conceptually.
  • For example, anti-takeover provision might have impact on business uncertainty. If so, it will affect the use of EA and debt contracting simultaneously. Therefore, it violates the exclusion restriction condition.
Suggestions-alternative explanation

- CEO reputation might affect the likelihood of contracting explicitly with the board.
- CEO reputation might also affect debt contracting.
- CEO reputation might constitute a correlated omitted variable.