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Deferred compensation withdrawal decisions and their implications on inside debt[☆]

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ABSTRACT

Deferred compensation constitutes a significant portion of inside debt. Unlike pension plans, deferred compensation can be vested before retirement. If entrenched CEOs take advantage of this attribute of deferred compensation and withdraw it when the firm is in financial distress, the beneficial roles of deferred compensation as a tool for aligning the CEO's interests with those of debtholders are undermined. Moreover, there would be a need to reexamine existing empirical studies in this area which obtain the amount of inside debt by simply adding the monetary value of pension and deferred compensation. This study examines whether deferred compensation can serve as inside debt in real world practices. Using a large sample of S&P 1,500 firms, I find that entrenched CEOs tend to restrict the decision of deferred compensation withdrawal in order to protect debtholders' value when a firm's distress risk is significant. Therefore, deferred compensation serves as an important alignment role with debtholders in spite of the existence of withdrawal flexibility.

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I. Introduction

From a firm's perspective, the payment structure of pension and deferred compensation plans is similar to that of debt contracts, where the liability equals the present value of payments pledged to its executives. For this reason, both forms of plans are referred to as "inside debt" (a term first used by [Jensen and Meckling, 1976](#)). In a majority of U.S. firms these benefits are unsecured and unfunded obligations, exposing executives to the same default risks and insolvency treatment as other creditors. In line with this observation, recent empirical studies examine the roles of a CEO's inside debt such as pension and deferred compensation on corporate policies and the capital market.¹ The findings of these studies are highly consistent with the theoretical predictions of [Jensen and Meckling \(1976\)](#) and [Edmans and Liu \(2011\)](#) that CEOs with a significant amount of inside debt manage firms more conservatively because they have incentives that are aligned with debtholders' interests.

It is important to note that vesting requirements are very different for pension and deferred compensation plans. In general executives are able to vest their pension money upon retirement except a few special cases.² On the other hand,

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¹ See for example, [Anantharaman et al. \(2014\)](#), [Bekku et al. \(2016\)](#), [Bennett et al. \(2015\)](#), [Cassella et al. \(2012\)](#), [Liu et al. \(2014\)](#), [Phan \(2014\)](#), and [Wei and Yermack \(2011\)](#).

² Based on a firm's proxy statement, these exceptions include the fulfillment of the minimum years of service, the change in control, and disability.

executives are given more flexibility to vest their deferred compensation money before retirement. During the 2007–2013 sample period, I find that 11% of CEOs withdrew their deferred compensation prior to retirement, with the mean (median) amount being \$1.65 (\$0.25) million. Therefore, it is possible that CEOs may withdraw their deferred compensation when inside information suggests that the firm is about to fail.³ If this is the case, the fundamental assumption of inside debt – unsecured and unfunded obligations, exposing executives to the same default risks and insolvency treatment as other creditors – is undermined. However, existing empirical studies do not distinguish between these two classes of plans and treat them as a homogeneous form of retirement benefit (i.e., they estimate inside debt value by simply adding the monetary value of both pension and deferred compensation). This means that CEO deferred compensation withdrawal practices may challenge major findings of existing inside debt studies.

This study examines whether deferred compensation can serve as inside debt by proposing two competing hypotheses. To the best of my knowledge, this is the first attempt to formally examine the deferred-compensation withdrawal decision, as linked to a firm's financial conditions. The CEO rent extracting hypothesis states that entrenched CEOs use their power to withdraw their deferred compensation balance prior to retirement when the firm's default risk is high. On the other hand, the incentive alignment hypothesis states that entrenched CEOs restrict the opportunity of deferred compensation withdrawal in order to protect debtholder's value when a firm's distress risk is significant. Using a large sample of S&P 1500 firms from 2007 to 2013, I find that a CEO's deferred compensation withdrawal decision is negatively associated with a firm's distress risk and a CEO's entrenchment. This result suggests that entrenched CEOs do not exploit the attribute of deferred compensation, but instead tend to restrict deferred compensation withdrawal decision in order to protect debtholders' value, especially when the firm is financially distressed. In light of the above evidence, deferred compensation can serve as an important alignment role with debtholders despite the existence of withdrawal flexibility.

The remainder of this paper is organized as follows. Data sources and sample characteristics are discussed in [Section II](#). [Section III](#) investigates the effects of CEO entrenchment and a firm's financial conditions on deferred compensation withdrawal actions. Summary and conclusions are provided in [Section IV](#).

II. Data and sample

The initial information on executive compensation is obtained from the summary compensation from the Standard & Poor's ExecuComp database for S&P 1500 companies from 2007 to 2013.⁴ Next, I merge the detailed pension and deferred compensation information from the pension dataset and deferred compensation dataset. After constructing the merged compensation dataset, I merge corporate governance and other executive information from ISS (Institutional Shareholder Services), firm financial statement data from Compustat, and common stock returns from CRSP respectively. These requirements reduce the sample to 8747 observations, with an average of 1249 firm observations per year. Finally, financial and utility companies are excluded. As a result, the final sample consists of 6657 firm-year observations, with an average of 951 firm observations per year.

[Table 1](#) provides the descriptive statistics of the key variables, which are defined in detail in the Appendix to this paper. All continuous variables are winsorized at 1% and 99%.

The average accumulated actuarial present values of pension and deferred compensation are \$2.85 million and \$2.24 million, respectively. When I add these two components of executive retirement benefit plans (normally referred to as inside debt), the mean (median) value of inside debt is \$ 5.20 (\$0.70) million. In particular, 11% of CEOs withdraw their deferred compensation before retirement with the mean (median) amount being \$1.65 (\$0.25) million. Therefore, the reported sample descriptive statistics indicate that deferred compensation plans constitute a significant portion of inside debt. If the deferred compensation withdrawal is the result of a CEO's discretion for his/her private benefits, the beneficial roles of inside debt is compromised and we should re-visit the existing empirical studies.

Panels B and C of [Table 1](#) report a firm's governance and financial characteristics, respectively. Approximately 51% of the CEOs chair their respective boards. The average (median) E-index, which is an anti-takeover provision (ATP) index from [Bebchuk et al. \(2009\)](#) is 2.5 (2).⁵ The average board size is 9 and the number of directorships of other public companies per director and outside director is 0.87 and 0.96, respectively (both serve as busy board indicators).

I follow [Campbell et al. \(2008\)](#) in measuring a firm's closeness to distress.⁶ Large DD values indicate safer firms. The mean (median) value of distance to default (DD) in our sample is 12.686 (8.248), indicating that average (median) firms are subject to relatively low default risk.

³ A famous example is the case of Enron where its executives withdrew millions of dollars of deferred compensation, shortly before Enron filed for bankruptcy.

⁴ Since December 15, 2006, the amended SEC disclosure rules require companies to report the present value of accumulated pension benefits and the aggregate balance of non-qualified deferred compensation for each top executive and each plan. Due to the new SEC disclosure rule, executive pension and deferred compensation data are available since 2006. However, given the large number of missing data in 2006, my sample starts from 2007.

⁵ Another widely used ATP index is G-index from [Gompers et al. \(2003\)](#). The G-index is based on 24 anti-takeover provisions while the E-index is based on 6 out of the 24 provisions. RiskMetrics made significant changes to their data sources and methodology starting 2007. As a result, many of the inputs required to calculate the G-index are no longer provided by ISS (formerly RiskMetrics).

⁶ [Campbell et al. \(2008\)](#) use the structural approach of Moody's KMV ([Crosbie and Bohn, 2001](#)), based on the structural default model of [Merton \(1974\)](#). To implement the structural approach, they follow the manner of [Hillegeist et al. \(2004\)](#) by solving a system of two nonlinear equations. The calculation details are available in the Appendix of [Campbell et al. \(2008\)](#).

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