

Contents lists available at [SciVerse ScienceDirect](#)

## Journal of Corporate Finance

journal homepage: [www.elsevier.com/locate/jcorpfin](http://www.elsevier.com/locate/jcorpfin)The prevention of excess managerial risk taking<sup>☆</sup>Edward D. Van Wesep<sup>\*</sup>, Sean Wang<sup>1</sup>

University of North Carolina's Kenan-Flagler Business School, Campus Box 3490, McColl Building, Chapel Hill, NC 27599, United States

## ARTICLE INFO

## Article history:

Received 11 May 2012  
 Received in revised form 8 April 2013  
 Accepted 23 April 2013  
 Available online xxxx

## JEL codes:

J33  
 M55

## Keywords:

Severance pay  
 Executive compensation  
 Empire building

## ABSTRACT

Executives with poor prior performance may be inclined to take excessive risk in the hope of meeting performance targets, in which case a compensation contract featuring severance pay can be optimal. While prior work has shown that severance can induce managers to take positive NPV risks, we show that it can also keep them from taking negative NPV risks. We show that severance should be contingent on results: complete failure should nullify any payments. We also show that mandating a firm size that is larger than first-best, while costly, can help screen for good managers.

© 2013 Published by Elsevier B.V.

## 1. Introduction

Managers are typically viewed as overly risk averse (Guay, 1999; Smith and Stulz, 1985), and the prior literature on contract design has focused on increasing managers' willingness to take risk via equity grants, stock options, and severance pay.<sup>2</sup> These efforts appear, in practice, appear to be effective.<sup>3</sup> But there are many situations in which even a risk averse manager would take excessive risks, in particular when she finds herself close to missing earnings targets.<sup>4</sup> The CEO may prefer to take negative NPV risks to at least have some shot at meeting performance targets. We show that an optimal contract will often set high performance goals, higher even than first-best for any type of manager, and offer severance for executives who do not meet the bar. We also show that the features of these contracts appear to match several stylized facts about severance agreements that we see in practice.

<sup>☆</sup> The authors would like to thank B Douglas Bernheim, Jon Levin, Andres Almazan, and Scott Schaefer for helpful comments. Edward Van Wesep would like to thank the Taube Foundation for financial support. All errors are ours.

<sup>\*</sup> Corresponding author. Tel.: +1 919 360 9689.

E-mail addresses: [vanwesep@unc.edu](mailto:vanwesep@unc.edu) (E.D. Van Wesep), [sean\\_wang@unc.edu](mailto:sean_wang@unc.edu) (S. Wang).

<sup>1</sup> Tel.: +1 919 962 0284.

<sup>2</sup> See, for example, Core and Guay (1999), Core and Guay (2002), Lys et al. (2007), Yermack (2006), and Manso (2011).

<sup>3</sup> Some examples of riskier decisions, as reported in Coles et al. (2006) include relatively higher investment in R&D, lower investment in PP&E, a more excessive use of cash (lower cash balances), a stronger focus on fewer lines of business, and higher leverage.

<sup>4</sup> Indeed, prior literature studying the actions of money managers, such as Chevalier and Ellison (1997), show that mutual fund managers increase the riskiness of portfolios in the fourth quarter when their return is below comparable benchmarks, while Green (2009) shows that hedge fund managers use discretion in their abilities to mark-to-market Level 3 Assets in order to achieve their desired reporting targets. A large literature on CEO behavior has shown that they are willing to make value-destroying decisions regarding advertising, pricing, production levels, R&D and asset sales in order to meet financial reporting targets. For example, see Baber et al. (1991), Dechow and Sloan (1991), Bartov (1993), Bushee (1998), Graham et al. (2005), Roychowdhury (2006), and Wang and D'Souza (2008). These papers largely concern the tendency of managers to manipulate earnings to beat internally or externally defined benchmarks, like analyst forecasts, prior earnings, or management guidance. While there may be no explicit incentive tied to these benchmarks, the implicit incentive appears sufficient to drive behavior. The benchmarks we derive in our paper may be formally written or informally understood, but serve an identical purpose in either case.

In our model, a board chooses a potential CEO it believes to be a good fit with the firm and makes a contract offer. A contract describes what she is to be paid and whether she will be fired, both as a function of the profitability and size of the firm under her leadership. After accepting the contract and joining the firm, the CEO may find that her best efforts will be insufficient to reach the performance targets set by the board. Her decision, then, is whether to “do her best” and under-perform, knowing that she may be fired, or to take negative NPV risks to attempt to meet her performance targets.<sup>5</sup> Our results demonstrate that if the board wishes to prevent the manager from taking excessive risk, it is often the case that a contract featuring severance pay is the least expensive way to induce good behavior from mediocre managers.

The model requires two critical features. First, there must be multiple periods for the concept of “firing” to make sense. Second, there must be a trade-off between expected profit and risk, where an increase in the latter corresponds to a decrease in the former. The model incorporates these two features in the simplest possible way: there are two periods, and profit can take either a high value or a low value. The low value is always equal to zero, so the high value can be defined as the “targeted profit”. As this value increases, the expected profit is assumed to decrease.

While the simplicity is attractive in its own right, an additional benefit to the model is that we need not restrict the space of contracts that the firm may offer. It is often the case in contracting papers that attention is restricted to linear contracts, option contracts, etc. in order to make the problem tractable. By restricting the analysis to two potential outcomes, we are able to consider the full contracting space while still analytically deriving a simple closed form solution for the optimal contract.

We show that compensation packages including severance pay are most valuable when the additional expected profit from having a good manager is high and when ability of the board to screen candidates prior to the contracting stage is high. Importantly, the optimal severance contract pays CEOs who achieve mediocre profits, but not those who fail completely. Pay for truly poor performance actually provides incentives for risk taking, as poor performance typically results from a failed risky action.

The contract will also mandate empire building, in the sense that good managers are expected to choose a firm size above that which is first-best.<sup>6</sup> The intuition is that increases in firm size, beyond first-best, have two effects. First, the profitability of the firm decreases. Second, the probability of achieving targeted profitability for the lower quality CEO is decreasing in firm size, so a larger required size allows the firm to decrease severance pay while still ensuring that the lower quality CEO does not engage in risk taking. In the neighborhood of the first-best firm size, the former effect is second-order while the latter effect is first-order.

In fact, trivial extensions to the model would yield optimal contracts requiring high quality CEOs to take many actions that are excessive relative to the first-best. Any firm attribute that is complementary to CEO skill in determining firm profit could be inserted instead of, or in addition to, firm size without changing our results. For example, if it is more difficult for a lower quality CEO to manage a firm with more divisions, than the firm will require a high quality CEO to choose more than the first-best number of divisions. This model produces empire building and conglomerating as part of an optimal contract.

The existing literature on severance pay as a component of an optimal compensation scheme has focused on a number of different themes. Kahn (1985) demonstrates that when profits are noisy and firing of high quality executives takes place on the equilibrium path, severance payments can allow for efficient risk sharing. Similarly, Manso (2011) suggests that severance can induce optimal risk taking when failure can be a result of either shirking or (efficient) risk taking. Almazan and Suarez (2003) use severance as a method of solving a commitment problem by allowing boards to only fire executives when a replacement is significantly better.<sup>7</sup> Walkling and Long (1984) and Lambert and Larcker (1985) demonstrate that severance payments can align management and shareholder interests by compensating managers for loss of a job in the case that their firm is acquired. Schleifer and Vishny (1989) and Scharfstein and Stein (2000) argue that severance may result from non-arms-length bargaining where managers are entrenched and are effectively able “write their own paychecks”.

Laux (2008) examines a setting that varies CEO-board independence and concludes that because the board’s propensity to terminate the CEO is positively correlated with independence, severance pay should be included in an optimal contract to induce self-revelation of low-type CEOs. He then shows that because these severance contracts have adverse incentives on a CEO’s effort level, optimal contracts should compensate for this by increasing the level of stock options. Roman and Mueller (2010) reach similar conclusions regarding severance pay and incentive pay, without varying levels of board independence. The motivation of both of these papers is Levitt and Snyder (1997), who show in a more generalized setting that poorly-performing agents must be rewarded by the principal in order to receive early warning of the agent’s performance.

While our paper has similarities with the aforementioned, our main intent is not to shed further light on the use of compensation to reveal negative information or the poor fit of CEOs with their respective firms. Rather, we contribute by demonstrating that severance pay can be used to avoid excessive managerial risk-taking and firm-value destruction, particularly when the executive has significant pressures to meet performance-benchmarks. The two most important empirical implications from our model that differ from others in the literature are that, (i) severance should not be paid for truly horrendous performance, and (ii) empire building is optimal for good, but not bad, managers. These aspects of the manager’s contract should arise only if (iii) there is significant opportunity for her to take unobservable, negative NPV risks, and (iv) it is likely that the manager is high quality.

Section 2 outlines the simple model underlying the discussion. Section 3 derives the set of possible optimal contracts and shows how parameters affect which out of this set is best. Section 4 concludes. Proofs are provided in the Appendix A.

<sup>5</sup> Whether she will be fired for missing performance targets is endogenously specified in the initial contract.

<sup>6</sup> Empire building, or the managerial practice of choosing a sub-optimally large group of underlings (the entire firm, for a CEO), has been documented for some time. The typical explanation for empire building is that it confers some private benefit to the manager in the form of job safety, perks, additional income etc. In this paper, the manager will be required to empire build by the board.

<sup>7</sup> In particular, severance in their setting commits boards to only replace managers when replacement is most valuable. This ex-post protection induces ex-ante optimal investment by managers.

Download English Version:

<https://daneshyari.com/en/article/5093518>

Download Persian Version:

<https://daneshyari.com/article/5093518>

[Daneshyari.com](https://daneshyari.com)