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Abstract

This article investigates the impact of the observation that managers can use cash to defer bankruptcy on default risk and corporate financial policies. I show that with managerial cash use to defer default, the impact of cash on default risk depends on two opposing channels. While cash provides managers with a buffer against bankruptcy during difficult times, it also reduces equityholders' willingness to contribute funds to the firm, which increases bankruptcy risk. The total impact of cash on default risk is driven by firm and industry characteristics that affect the relative importance of these two channels. As managers' propensity for excess cash holdings depends on this total impact, the model explains observed excess cash levels, their determinants, and a wide range of empirical regularities of corporate cash holdings properties.

Keywords: Excess cash, Default risk, Managerial control

JEL classification: G32, G33

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1. Introduction

The main difference between debt or equity funds and corporate cash balances is that cash provides unconditional liquidity discretionary available to managers at any time. According to the survey of Lins et al. (2010), the most prominent reason for managers to hold non-operational cash is that these holdings can serve them a self-preservation motive, i.e., a basic financial insurance function as a buffer against corporate bankruptcy by allowing to fund current operations in bad times. Given the extent to which the literature examines the effect of managers spending cash

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