

How costly is corporate bankruptcy for the CEO?[☆]B. Espen Eckbo^{a,b,d,*}, Karin S. Thorburn^{b,d,e}, Wei Wang^c^a Amos Tuck School of Business, Dartmouth College, Hanover, NH 03755, USA^b Norwegian School of Economics, Helleveien 30, 5045 Bergen, Norway^c Stephen J.R. Smith School of Business, Queens University, Kingston, Ontario K7L3N6, Canada^d ECGI, c/o the Royal Academies of Belgium, Palace of the Academies, 1000 Brussels, Belgium^e CEPR, 33 Great Sutton Street, London EC1V 0DX, UK

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ABSTRACT

We examine chief executive officer (CEO) career and compensation changes for large firms filing for Chapter 11. One-third of the incumbent CEOs maintain executive employment, and these CEOs experience a median compensation change of zero. However, incumbent CEOs leaving the executive labor market suffer a compensation loss with a median present value until age 65 of \$7 million (five times pre-departure compensation). The likelihood of leaving decreases with profitability and CEO share ownership. Furthermore, creditor control rights during bankruptcy (through debtor-in-possession financing and large trade credits) are associated with CEO career change. Despite large equity losses (median \$11 million for incumbents who stay until filing), the median incumbent does not reduce his stock ownership as the firm approaches bankruptcy.

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1. Introduction

Corporate bankruptcy can impose personal costs on the firm's chief executive officer (CEO), ranging from forced career change to loss of labor market capital and equity value. These costs are of great interest to corporate finance because they can incentivize CEOs to hedge against bankruptcy risk at the expense of shareholder value. For example, one finds references to this hedging incentive in studies of large corporate cash balances (Bates, Kahle and Stulz, 2009), near-zero leverage firms

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(Strebulaev and Yang, 2013), and firms that could switch to low-risk investments when approaching bankruptcy (Eckbo and Thorburn, 2003; Eisdorfer, 2008). The concept of personal costs of corporate bankruptcy is also used in the context of optimal design of nonexecutive labor contracts (Berk, Stanton and Zechner, 2010; Chemmanur, Cheng and Zhang, 2013).

Notwithstanding its importance, evidence on CEO personal costs arising from corporate bankruptcy in the US is sparse. Some evidence exists on CEO compensation losses associated with Chapter 11 filings in the 1980s (Gilson, 1989; Gilson and Vetsuypens, 1993). However, over the past decades, Chapter 11 has evolved toward a more creditor-oriented process (Ayotte, Hotchkiss and Thorburn, 2013; Jiang, Li and Wang, 2012), which by itself can impact CEO personal costs of corporate bankruptcy. In this paper, we provide large-sample evidence on CEO career and compensation changes in the modern era of Chapter 11. With the exception of Eckbo and Thorburn (2003), who use Swedish tax returns to show changes in CEO labor market income after bankruptcy filing, the type of longitudinal employment and compensation change information that we analyze is largely new to the literature on Chapter 11 bankruptcy (Hotchkiss, John, Mooradian and Thorburn, 2008).

Does the executive labor market punish CEOs who file for Chapter 11? The answer is likely complex. On the one hand, the CEO could have paid insufficient attention to the firm's operational and financial policies, including a failure to restructure the untenable set of financial claims against the firm. On the other hand, this criticism could be muted by a realization that forces beyond the CEO's control, such as technological and regulatory changes, also contribute to financial distress. Moreover, the decision to file can be viewed positively by the labor market because it halts further slide toward costly liquidation and adds valuable crisis management experience to the CEO's skill set. The net effect of these considerations for CEO career opportunities and changes in CEO labor market capital is a largely unresolved empirical question, which our evidence addresses.

In this paper, we trace CEO employment through bankruptcy and estimate the loss of labor market capital by comparing the CEO's compensation before and after bankruptcy. Our sample consists of 322 Chapter 11 filings in the period 1996–2007 by large, publicly traded US companies. We focus on the career changes of the incumbent CEO, defined as the CEO in charge of the firm at the fiscal year-end three years prior to bankruptcy filing (event year -3). Moreover, we single out the 18% of the incumbents who are company founders. This is somewhat higher than the 11% founder CEOs reported by Fahlenbrach (2009) for large public US firms outside of bankruptcy.

For comparison, we also include the CEOs hired to replace the incumbents during the bankruptcy event period from year -2 through the year after emergence (event year *Emergence*+1). One can reasonably expect that the incumbent CEO is more likely to be held responsible for the firm's demise than a replacement CEO hired closer to or after filing. At the same time, a founder incumbent can have firm-specific human capital that is valuable for the

distressed firm (Adams, Almeida and Ferreira, 2009; Anderson and Reeb, 2003; Fahlenbrach, 2009).

The analysis is performed in five steps. First, we determine to what extent the CEO continues at the helm of the restructured firm or leaves over the bankruptcy event period. CEO turnover is high. Of the 322 incumbents, 86% leave before year-end *Emergence*+1. The departures are classified as either voluntary or forced, defined as performance-related or following pressure from the board, shareholders, or creditors. We find that founder incumbents are marginally less likely to be forced out than non-founder incumbents. Moreover, forced turnover increases with fraud allegations and with creditor control rights during bankruptcy. A channel for the latter effect is covenants imposed by debtor-in-possession (DIP) financing lenders. Multivariate regressions further indicate that CEOs with greater percentage share ownership are less likely to leave the firm voluntarily, as if equity ownership provides an incentive to stay with the firm as it approaches bankruptcy.

Second, for a CEO who leaves his position, we record any new employment within three years using public sources such as industry manuals, press releases, and social media. We positively identify the employment or retirement for 81% of the 322 incumbent CEOs and classify the remaining 19% as retired. Approximately one-third of all incumbent CEOs leave for a new executive position or remain CEO of the restructured firm after emergence. The remaining two-thirds leave the executive labor market to assume nonexecutive directorships on corporate boards, become consultants, or retire. The likelihood of leaving the executive labor market is positively associated with relatively poor operating performance, DIP financing, and allegations of financial fraud. While incumbent CEOs are more likely to leave without assuming a new executive position than replacement CEOs, no significant difference emerges in the full sample between founders and nonfounders.

Third, we find the CEO's compensation in his new career and compare that with his compensation at the bankrupt firm. For CEOs who continue as executives at public firms, we collect the new compensation from ExecuComp or Securities and Exchange Commission (SEC) filings (proxy statements and form 10-K). For those who become executives at private firms, we follow the literature and estimate the new compensation as the executive compensation for a public company matched on two-digit standard industrial classification (SIC) industry and size (Core, Holthausen and Larker, 1999; Harford and Li, 2007; Kaplan and Rau, 2010; Murphy, 1999), adjusted by a 20% private-firm discount (Gao, Lemmon and Li, 2011; Gao and Li, 2015).

We compute the present value (PV) of the compensation change (new minus old) through age 65 as a measure of the effect of the bankruptcy event on the CEO's labor market capital. As some CEOs retire voluntarily, this PV represents an upper bound on the incumbent CEO's change in labor market capital due to bankruptcy. For incumbents (founders as well as nonfounders) who maintain executive employment, the median estimated compensation change is statistically indistinguishable from zero. This holds regardless of whether the CEO stays with the restructured firm or assumes an executive position at another firm.

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