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Shareholder governance, bondholder governance, and managerial risk-taking

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ABSTRACT

We examine the relation between the overall corporate governance structure and managerial risk-taking behavior. We find that the overall governance structure has a significant impact on how managers make decisions on investment policy: strong bondholder governance motivates more low-risk investments such as capital expenditure and lower high-risk investments such as R&D expenditures, whereas weak shareholder governance (entrenched managers) leads to more R&D expenditures. Moreover, we find that the effects of governance on investment policy differ significantly between speculative and investment-grade firms. For speculative firms, strong bondholder or shareholder governance leads to more capital expenditures and low R&D investments. For investment-grade firms, strong bondholder or shareholder governance leads to low capital expenditures and an insignificant impact on R&D investments. Furthermore, financing and investment covenants exhibit strong binding power to deter risky investments. Finally, a more dependent (or a less independent) board is associated with low capital expenditures and high R&D investments.

1. Introduction

The study of corporate governance has attracted much attention from academic researchers, practitioners, and policymakers over the past several decades. In light of the recent global financial crisis, the importance of effective corporate governance structures cannot be emphasized enough. On the theoretical front, Albuquerue and Wang (2008) and Dow et al. (2005) present theoretical models on how imperfect corporate control and agency conflicts affect asset pricing. On the other hand, there has been an extensive strand of empirical literature on various governance controls on equity and bond prices. For example, Gompers et al. (2003) create an index (hereafter G-Index) based on 24 antitakeover provisions and find that firms with stronger shareholder rights (a lower G-Index) have higher equity and firm values. In a recent paper, Cremers et al. (2007) highlight the importance of bondholder governance through the use of bond covenants and present the interactions between shareholder and bondholder governance mechanisms. More specifically, they focus on three bond covenants that are closely related to takeover defenses: net worth restrictions, leverage restrictions, and poison puts. In particular, they suggest that bondholder governance helps mitigate potential conflicts between shareholders and bondholders and its interactions with shareholder governance affect bond prices. The implication is that further investigation of the combined effects of the governance structure consisting of shareholder and bondholder governance is critical in the research of corporate governance.

We examine how corporate governance affects the risk-taking behaviors of managers on an integrated basis by recognizing the overall corporate governance structure consisting of shareholder governance represented by antitakeover provisions in corporate charters and by-laws and bondholder governance in debt covenants. The extant literature examines the shareholder rights and bondholder governance in two separate lines of research. One line of research focuses on the effects of bond covenants on managerial decisions. For example, Billett et al. (2007) examine how bondholder governance structured in debt covenants affects managerial decisions on debt maturity and leverage. Without considering the effects of shareholder governance on the managerial decisions, they find that covenant protection is increasing in growth opportunities, debt maturity, and leverage. They also suggest that the negative relation between leverage and growth opportunities is significantly attenuated by covenant protection, suggesting that debt covenants can mitigate the agency costs of debt for high-growth firms. The other line of research studies the effects of shareholder governance on managerial decisions with no consideration of the effects of bondholder governance. For example, Gompers et al. (2003) find that firms with a high G-Index are likely to invest more in capital expenditure than firms with a low G-Index, which they interpret as evidence of higher agency costs. In addition, the findings from John et al. (2008) suggest that firms with better shareholder protection are more likely to engage in

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riskier investment that can create firm value. Moreover, the main focus of the studies on shareholder governance is the effects of shareholder governance on equity prices or debt yields (Klock et al., 2005; Bhojraj and Sengupta, 2003; Gompers et al., 2003; Cremers and Nair, 2005; Jiraporn and Gleason, 2007).

It is important to examine the protection for *both* shareholders and bondholders in the corporate governance structure for the following reasons. First, current literature suggests that, when examined individually, either shareholder or bondholder governance structure has significant impacts on the wealth of the claimholders. One should examine the overall governance structure consisting of controls implemented by both claimholders. For example, Acharya et al. (2009) suggest that when one examines the impacts of shareholder rights on investment policy, creditor rights need to be controlled for. Second, shareholder and bondholder governance structures interact with each other, and managerial decisions are derived from the consideration of such interactions between the two structures. Certain types of shareholder governance can lead to possible wealth transfers between bondholders and shareholders. In the case of buyouts, shareholders prefer fewer takeover defenses to attract better monitoring of managers from the market for corporate control or eventually cash out with a substantial gain (Torabzadeh and Bertin, 1987; Lehn and Poulsen, 1989), and bondholders generally lose in buyouts, transferring wealth to shareholders (Asquith and Wizman, 1990; Baran and King, 2010). Alternatively, debt covenants weaken shareholder rights by restricting the managers from making certain value-creating investments (e.g., positive NPV projects) and guard against opportunistic behavior that decreases firm value (e.g., over-consumption of perks, overcompensation, shirking, and over-investing). For example, Billett et al. (2009) suggest that the change in the control covenant has a significantly negative effect on the likelihood of the firm being a takeover target. Literature suggests that the design of shareholder governance may harm the bondholders (or vice versa) due to the agency problems between the two stakeholders. The agency problems are summarized as follows: default risk concerns, takeover concerns, and asset substitution concerns. Therefore, shareholder and bondholder governance may overlap or create conflicts depending on their designs. As mentioned above, Cremers et al. (2007) highlight the interactions between shareholder and creditor protection and their impacts on bond yields. In addition to examining the interactions of shareholder and bondholder governance, we focus on the effects of overall governance on managerial risk-taking behavior. More specifically, we follow Coles et al. (2006) and use capital expenditure and R&D expense to represent risk-taking activities. R&D expense relates to the development of new products and services and is regarded as high-risk and long-term investments. On the other hand, capital expenditure on tangible assets is considered low-risk investments (Bhagat and Welch, 1995; Kothari et al., 2002). Given limited resources, the allocation of capital between R&D and capital expenditure reflects managers' inclination to take risks.

Prior research linking governance to bond and equity returns provides a test of an *indirect* relation. For example, Klock et al. (2005) find that a higher G-Index is associated with lower cost of debt. They suggest that these amendments reduce firm risk and cash flow variability and, therefore, protect the interests of the bondholders. However, they did not examine if corporate governance *directly* leads to managerial decisions that reduce firm risk. In addition, existing literature suggests that shareholder governance and management compensation influence the risk-taking activities of managers. Stein (1988) develops a model suggesting that when managers are sheltered by antitakeover amendments, they are more likely to engage in long-term projects. However, no empirical evidence has been provided therein. Coles et al. (2006) show a strong causal relation between managerial compensation and investment policy, debt policy, and firm risk that define managers' risk-taking behaviors. As managers' risk-taking behaviors have significant effects on the returns of claimholders, one should study the direct relation between governance structure and investment policy, which is the missing link in the literature. We fill in this gap by studying how the corporate governance structure affects managers' investment policy.

Finally, recent literature suggests that shareholder governance, bondholder governance, and managerial policy are interrelated and should be examined jointly. In particular, John and Litov (2009) suggest that entrenched managers are able to secure better financing terms (borrowing costs and covenants) partly due to a more conservative investment policy. Two implications follow. First, while one should examine how shareholder and bondholder governance affect managerial decisions, it is just as important to examine how managerial investment behavior in turn influences governance designs. Second, with respect to the existing literature on how shareholder governance affects financing decisions (Klock et al., 2005; John and Litov, 2009; Acharya et al., 2009; Chae et al., 2009), we claim that the use of debt and covenants is an alternative entrenchment device used by managers. We take one additional step to examine the interactions between shareholder governance and covenant design and their combined effects on managerial decisions, which have *yet* to be examined in the literature.

We find that bondholder governance structure varies across industries and becomes stronger over time. Shareholder governance structure, on the other hand, shows little variation across industries and remains relatively constant over time. We posit that the overall corporate governance structure consists of shareholder governance, measured by antitakeover provisions and bondholder governance in covenants. Under the simultaneous equations framework, we examine the relation between the firm's investment policy and the overall corporate governance structure. We find that strong bondholder governance leads to more low-risk investments such as capital expenditure and lower high-risk investments such as R&D investments. On the other hand, weak shareholder governance (high G-Index) is linked to high R&D expenditures, supporting the management entrenchment hypothesis. In addition, strong (weak) bondholder governance is often combined with weak (strong) shareholder governance. The results suggest that a firm's investment policy is determined by the combined and possibly conflicting effects of bondholder and shareholder governance. Risky investments result from a weak overall corporate governance structure, whereas strong overall governance leads to a conservative investment policy. A structure containing strong bondholder but weak shareholder governance (entrenched managers) suggests a mixed implication of risk-taking behavior, as bondholders prefer low-risk investments, while entrenched managers favor long-term projects with high payoffs. A similar implication holds for a structure with weak bondholder and strong shareholder governance. Lastly, firms with a large institutional ownership and a high-leverage ratio are more likely to have strong bondholder and shareholder governance than those with a small institutional ownership. Regulated firms invest more in low-risk projects and have a weaker bondholder and shareholder governance than non-regulated companies.

We further perform sub-sample analyses based on credit risk, financing covenants, and investment covenants, respectively. We find the relation between corporate governance and investment policy to be significantly different between speculative and investment-grade firms. For speculative firms, strong bondholder or shareholder governance leads to low-risk projects in terms of high capital expenditure and low R&D investment. For investment-grade firms, strong bondholder and shareholder governance lead to low capital expenditure and an insignificant impact on R&D. In