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Managerial replacement and corporate financial policy with endogenous manager-specific value

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Abstract

This paper studies financial policy, investment decisions and the threat of dismissal when managers value control and investments generate manager-specific value. A high probability of investigation focuses the manager on the profitability of replacement and therefore manager-specific value. The probability of an investigation increases when the firm enters bankruptcy. Thus, high debt levels focus the manager on investments that dissuade replacement during bankruptcy procedures. Dividends relax the manager's focus on manager-specific value since there is a lower probability of an investigation following a missed dividend. The ability to make dividend payments, however, is related to ex-post performance and can improve replacement decisions. When managerial quality is commonly known, the expected value of the firm is maximized with a combination of debt and dividend commitments. When managerial quality is hidden information, it is optimal for the combination of debt and dividend commitments to signal quality.

JEL classification: G3; K22

Keywords: Managerial discipline; Financial commitments; Firm-specific value; Bankruptcy investigations; Dynamic consistency

1. Introduction

Since the pioneering work of Modigliani and Miller (1958) and Miller and Modigliani (1961), there has been considerable progress in developing a robust theory of corporate

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financial policy. However, there remain many unexplained aspects of debt and dividend policies (especially the links between the two). This paper develops some potential determinants of debt and dividend policies arising from interactions between firm-specific value, managerial benefits of control and information asymmetries.

The importance of firm-specific value has long been recognized (Coase, 1937; Alchian and Demsetz, 1972; Williamson, 1985), and has increased significantly with the onset of the "knowledge economy" (in which the value of intangible assets now outweighs the value of plant, property and equipment on corporate balance sheets). An interesting dimension of firm-specific value is its relation to the study of potential agency problems that can arise from the separation between ownership of and control over corporate resources.

A potentially costly agency problem can arise when managers become concerned with protecting their positions. In addition to poison pills (see Jensen and Ruback, 1983), managers may undertake investments fostering firm-specific value that is tied directly to themselves, i.e. manager-specific value (Shleifer and Vishny, 1989). There is considerable evidence suggesting that managerial decisions are related to concerns with manager-specific value. Mitchell and Lehn (1990) find that managers alter the set of assets under their control (i.e. restructure) in response to a takeover threat. Dennis et al. (1997) and Lang et al. (1995) provide similar evidence suggesting that managers become concerned with their comparative advantage during periods of financial distress or takeover threats. Weisbach (1995) finds that divestitures are related to managerial replacement and that incoming CEOs often reverse the strategies of previous CEOs, and Dennis and Dennis (1995) find that competition for control increases significantly when incumbents are forced out.

The influence of the threat of dismissal on managerial decisions has been related to disciplinary actions by the board of directors (Weisbach, 1988), debt commitments (Gilson, 1988), takeovers and voting rights (Linn and McConnell, 1983; Roe, 1990; Stulz, 1988; Pound, 1991). More recently, researchers have studied the potential to improve managerial incentives by reforming bankruptcy laws (Jensen, 1991; Bradley and Rosenzwieg, 1992), takeover laws (Comment and Schwert, 1995), proxy rules (Karpoff et al., 1996), and board requirements (Brickley et al., 1995) to increase the threat of dismissal. Our paper contributes to this literature by extending the analysis back one period, and considering the incentives for ex-ante investment strategies that develop manager-specific value.

We develop a model in which the ex-ante incentive to pursue manager-specific value is influenced by the ex-post threat of dismissal. Ex-post replacement decisions must be dynamically consistent, and are therefore based on ex-post estimates of the profitability of replacement. These estimates depend on the information that is available ex-post, which depends on the intensity with which ex-post value is investigated and therefore the firm's ability to meet its financial commitments.

The link between financial commitments and managerial incentives is related to Jensen's (1986) free cash flow theory and Harris and Raviv's (1990) informational theory of debt, in which default causes an investigation that improves ex-post decisions. In our paper, default also causes an investigation that improves ex-post decisions. However, bankruptcy investigations are also linked to the manager's ex-ante investment