



Do corporate managers skimp on shareholders' dividends to protect their own retirement funds? ☆



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ABSTRACT

What is the impact of long-term executive compensation, particularly large pension payouts, on the firm's current dividend policy? We argue that managers with high pension holdings are less likely to adopt a high dividend policy that can risk their future pension payouts. Using a hand-collected actuarial pension dataset we show that (i) dividend payments are significantly lower when manager compensation relies more heavily on pension payouts; (ii) higher compensation leverage and inside debt have a significant negative effect on dividend payments net of stock repurchases; and (iii) the negative effect of pension on dividend is significantly weaker when pensions are protected in a pre-funding rabbi trust. We show further that this agency behavior reduces firm performance.

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1. Introduction

Corporate managers are assumed to represent the interests of shareholders, and thus should take actions that maximize the value of equity. Yet, managers often have their own incentives that may not be perfectly aligned with shareholders' interests. These include reputation concerns (Narayanan (1985)), empire-building interests (Jensen's (1986)) and risk-aversion due to undiversified wealth and human capital invested in the firm (Jensen and Meckling (1976); Treynor and Black (1976); Parrino et al. (2005)). There exist also compensation-based incentives: meeting short-term bonus targets (Waagelein (1988)), risk-taking incentives due to large stock-option holdings (Coles et al. (2006)), and lowering the likelihood of default that risks pension payouts (Sundaram and Yermack, 2007).

We investigate how compensation-based considerations, particularly the size of pension plans, affect the firm's current dividend policy. In general, the literature suggests that managers who are heavily compensated with debt-based instruments, such as pensions, tend to manage the firm more conservatively because they are exposed to default risk (Sundaram and Yermack, 2007; Cassell et al., 2012). While these studies focus on the default risk as a tool to protect future pension payouts, we analyze the cash flow policy effects. We argue that firm executives with high pension holdings will be reluctant to adopt a high dividend policy because this essentially commits the firm to a constant or growing level of dividends for the foreseeable future. Managers know, and the literature confirms, that once a firm starts paying dividends, cutting or omitting those dividends will have negative consequences in terms of both the

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stock price and the reputation of the managers (see, e.g., [Michaely et al. \(1995\)](#)). Thus, executives may be hesitant to commit the firm to large cash distributions that might leave fewer funds available for future pension payouts. Instead managers can elect to either keep funds in the firm or distribute cash to shareholders in the form of stock buybacks. The benefits of these options are clear as they do not commit the firm to permanent future cash payouts.

To estimate the present value of pensions we manually collected data on pension plans for 272 of the largest firms listed on the U.S. stock exchanges over a ten-year period between 2000 and 2009. Instead of a CEO-only database used in previous studies, we collect data on all firm executives (typically five per firm-year). We measure the importance of pension in two ways. The first is the present value of the manager's pension divided by the sum of this present value and the values of stocks and stock-options held by the manager (this ratio is typically referred to as 'compensation leverage'). The second is the pension's present value divided by the book value of the firm's total assets. The first measure is designed to capture the relative importance of pensions in the manager's long-term compensation package, while the second captures the magnitude of the firm's inside debt. We also apply two measures for the level of dividends. First is the dividend yield, defined as the annual dividend per share divided by the stock price at the end of the year. The second measure is the dividend payout ratio, defined as dividends paid during a given year divided by the income available to shareholders in the same year.

Regression results support our theory: high levels of compensation leverage and inside debt are associated with consistently lower dividend yield and dividend payout ratio. This association remains significant when we examine the compensation of CEO-only and all top executives; the results are robust to the estimation procedure and various subsamples. We further show that the observed effect of executive pensions on dividend policy is not driven by endogeneity – i.e., by the possibility that firms that typically maintain a lower level of dividends can direct more funds into pension plans.

The results above capture the effect of pension plans on the managers' decision to pay dividends against all other possible uses of the firm's cash, including re-investment or keeping funds in the company. We further explore the relationship between pension values and the form of cash payouts. That is, after deciding the optimal level of cash to distribute to shareholders, the manager must choose the form of the payout: cash dividend or stock repurchase. We predict that managers with higher future pension claims will prefer cash distributions in the form of a stock repurchase because it is perceived as a one-time payout, while dividends are viewed as a long-term commitment. We find that the main results hold when adjusting the dividend payments for net stock repurchases.

Another interesting finding of our study is related to the level of protection of the executives' pensions. We examine the details of the individual pension contracts and find that a sizeable proportion of our sample firms (24%) offer pre-funded pensions via a rabbi trust. Funding a pension prior to the executive's retirement appears to weaken the cash-preserving incentive of the manager because the risk of losing her pension is significantly neutralized. Alternatively stated, the negative effect of pension plans on dividend policy is significantly stronger when pensions are unfunded.

Last, we examine the costs associated with pension-dividend agency behavior. We argue that in making payout decisions, managers who have pension-based considerations will be less committed to maximizing firm value. Specifically, managers who are reluctant to initiate or increase dividend payments, because they want to protect their future pension payouts, will be more likely to direct the firm's funds into less-than-optimal investment channels. To test this proposition, we look at common proxies of operating performance (ROA, ROE, and ROI) in the subsequent years as a reflection of the quality of current investments. We find that when a change in dividend policy is associated with larger pension plans, it is more likely to reduce the firm's operating performance. This finding provides further support for the existence of the agency problem analyzed in this study.

Our paper contributes to the literature by highlighting an aspect of agency theory that has not been analyzed: saving shareholders' dividends for managers' retirement. Prior studies have shown that managers can deviate from value-maximizing corporate decisions in order to serve their own interests, such as reputation concern, empire-building incentives, and short-term compensation targets. Along this line, we find that managers who are entitled to high, and especially unprotected, pension payments typically prefer low cash dividend distributions to safeguard their future pensions.

The paper proceeds as follows. The next section reviews the related literature. [Section 3](#) states our hypotheses, [Section 4](#) outlines the estimation procedures, [Section 5](#) describes the data, [Section 6](#) tests the hypotheses, [Section 7](#) explores the costs of the agency behavior, and [Section 8](#) concludes.

2. Related literature

The theory on the separation of ownership and control for the modern corporation appears to have originated with [Berle and Means \(1932\)](#). This early analysis has evolved into the modern concept of agency theory as a result of the influential work of [Jensen and Meckling \(1976\)](#). The basic premise is that non-owner managers can adopt corporate decisions that serve their interests at the expense of the owners. Building on this concept, the theoretical literature has identified a variety of incentives that can lead managers to deviate from policies that maximize shareholder value.

For example, undiversified wealth and human capital invested in the firm may lead risk-averse managers to make sub-optimal decisions to reduce firm risk (see, e.g., [Jensen and Meckling \(1976\)](#), [Treyner and Black \(1976\)](#), and [Parrino et al. \(2005\)](#)). Another example is known as the empire-building hypothesis (see [Jensen, 1986](#)): executives of bigger firms appear to have more prestigious jobs. Thus, managers have a built-in incentive to increase the size of their company to achieve more prestige in society; this incentive can lead to over-investment that, in turn, reduces shareholder value. Similarly, reputation considerations can lead managers to make decisions that yield short-term gains at the expense of the long-term interests of the shareholders (see [Jensen and Meckling \(1976\)](#),

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