Journal of Banking & Finance 54 (2015) 115–128

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

CEO entrenchment and corporate liquidity management

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ARTICLE INFO

Article history:
Received 20 December 2013
Accepted 25 January 2015
Available online 2 February 2015

JEL classification:
G390

Keywords:
CEO entrenchment
Corporate liquidity management
Stakeholders

ABSTRACT

CEO entrenchment distorts firms' liquidity policy because entrenched CEOs and shareholders have conflicting preferences for liquidity. We investigate the association between firms' liquidity level/mix and entrenchment within a system model accounting for endogeneity. Several results are obtained. Entrenched CEOs (i) hold more liquidity because it helps reduce their firm's risks, provides them with job and wealth security, and gives them discretion in pursuing personal objectives; (ii) prefer cash over lines of credit (LCs) because the latter are accompanied by bank monitoring; and (iii) use more LCs, despite their associated monitoring, because they provide extra liquidity. Sample disaggregation shows that increased liquidity due to CEO entrenchment can be attributed to smaller and more opaque firms – large and transparent firms maintain their liquidity levels but increase their shares of cash. These findings imply that firms should align the interests of entrenched CEOs with those of shareholders to reduce the undesirable effects of entrenchment on liquidity management.

1. Introduction

Since capital markets are subject to frictions, firms cannot always obtain financing on a timely basis, if at all. Thus, liquidity management is an important component of overall corporate policy, especially for businesses facing greater market frictions such as younger, smaller, and more opaque firms (Almeida et al., 2004). Cash and lines of credit (LCs) are two major sources of liquidity. According to Sufi (2009), 87% of public firms and 64% of large private firms have access to LCs.[1] The literature on LCs is scarce despite their importance as a key source of liquidity; research on corporate liquidity has instead focused on the role of cash.[2]

According to the agency theory, managers in corporations with diffused ownership tend to pursue their own interests, instead of maximizing shareholders' wealth (Jensen and Meckling, 1976). This conflict of interest between shareholders and managers becomes particularly severe when managers are entrenched (Pan, 2007) as this further constrains the power of shareholders to replace or discipline managers. Managerial entrenchment is undesirable because it results in curtailment of shareholders' wealth (Easterbrook, 1984; Jensen, 1986; Pan, 2007). In particular, entrenched managers tend to attain more latitude in shaping corporate strategy, extracting larger compensation and perquisites for themselves (Shleifer and Vishny, 1989), and making more value-destroying acquisitions (Jensen, 1986; Morck et al., 1990; Lang et al., 1991). For example, Cronqvist et al. (2009) report that entrenched CEOs are likely to pay their workers a greater pay to enjoy private benefits such as lower efforts in wage bargaining. Ghosh et al. (2011) find that firms with an entrenched CEO use less leverage and issue debt with shorter maturities to reduce liquidity risk and to preserve their ability to enhance their wages and reputations through empire building. Kumar and Rabinovitch (2013) also find that firms with an entrenched CEO are more likely to engage in hedging to diminish firm risks.[3]

Studies on the effect of agency conflict on corporate liquidity policy have generally focused on the cash component of liquidity

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[1] Regulation S–K of the US Securities and Exchange Commission (SEC) requires firms to explicitly discuss their liquidity and capital resources in their annual 10-K SEC filings (Kaplan and Zingales, 1997).

[2] Studies considering LCs include Sufi (2009), Lins et al. (2010), Demiroglu and James (2011), and Acharya et al. (2013).

[3] Along similar lines, the work of Malmendier and Tate (2008) reveals that overconfident CEOs overpay for target companies and undertake value-destroying mergers, with these effects strengthening for firms in which the CEO has access to internal financing. Malmendier et al. (2011) also find that managerial characteristics have significant impacts on corporate financing decisions. For example, overconfident managers use less external financing, than their peers, CEOs who grew up during the Great Depression carry less debt and rely more on internal financing, and CEOs with military experience pursue more aggressive policies such as maintaining higher leverage levels.

http://dx.doi.org/10.1016/j.jbankfin.2015.01.014
0378-4266/

and, overall, find that entrenched managers hold greater than optimal levels of cash and are likely to misuse the freely available cash for their own purposes (Jensen, 1986; Dittmar et al., 2003; Chen and Chuang, 2009). In this paper, we extend the framework of analysis to examine the effect of CEO entrenchment on total liquidity as well as its cash and LC components. We argue that firms' decisions regarding total liquidity are as important, if not more so, than those regarding the composition of liquidity. Our reasons are threefold. First, composition of corporate liquidity mainly affects a firm's average cost of liquidity (i.e., the average cost of holding a given level of liquid assets) including foregone interest on cash, loan commitment fees, and interest paid on LCs. However, liquidity composition is unlikely to significantly affect a firm's capacity to undertake new investment projects or its ability to satisfy its short-term liquidity needs, given that total liquidity is sufficient overall.[4] In contrast, the total liquidity held by a firm will affect both the firm's cost of liquidity and its scale of investment (Acharya et al., 2007). If the firm is holding excess total liquidity, the cost of total liquidity (i.e., the opportunity cost of holding cash, loan commitment fees, and interest paid on LCs) will increase accordingly.

Second, total liquidity affects a firm's probability of failure because it may be driven to default on its debt if it does not have enough liquidity to make interest payments or pay off its debt at maturity. Third, total liquidity affects firms' policies including levels and forms of equity payout (e.g., dividend versus share repurchase) and capital structure (Jagannathan et al., 2000; Almeida et al., 2004; Denis and McKeon, 2012). Faulkender and Wang (2006) and Pinkowitz and Williamson (2006) demonstrate that liquidity affects the overall firm value.

We investigate the relation between a firm's total liquidity (the sum of cash and LC divided over assets) and its liquidity mix (the proportions of cash and LC in their total) on the one hand, and CEO entrenchment on the other. We use the entrenchment index (E-Index) designed by Bebchuk et al. (2009) as our measure of CEO entrenchment because the provisions included in this index limit the power of shareholders.

We obtain several results. First, we find that firms' total liquidity is positively associated with the level of CEO entrenchment (E-index). This finding indicates that entrenched CEOs hold greater amounts of liquidity as percentages of the firms' assets in order to potentially provide reserves for possible losses, to be exposed to lower levels of liquidity risk and default risk, and to facilitate their own consumption of perquisites. Second, we find that the proportions of LC and unused LC (ULC) over total liquidity- [LC/(Cash + LC)] and [ULC/(Cash + ULC)]- are both negatively related to CEO entrenchment, indicating that entrenched CEOs prefer cash to LCs. One possible rationale is that LCs are, and cash is not, associated with covenants and monitoring.

Third, we find that ratios of cash, LCs, and ULCs over assets (Cash/assets, LC/assets, and ULC/assets) are all positively related to CEO entrenchment. The advantage of using these proportions, rather than proportions in total liquidity, is that this framework permits both cash and LC ratios to increase simultaneously. Our finding that both cash and LC ratios in assets do indeed increase with entrenchment suggests that although entrenched CEOs dislike the constraints and monitoring from banks providing LCs, they still hold greater amounts of LCs relative to their assets because of the extra liquidity that LCs provide. Fourth, we find that the increase in liquidity associated with entrenchment is driven by smaller and more opaque firms. Fifth, entrenched CEOs of large and transparent firms maintain their total liquidity ratios in assets, but alter their liquidity mixes by raising their cash holdings at the expense of LCs.

We contribute to the literature in, at least, three ways. First, we are the first to study the association between CEO entrenchment and the total liquidity of firms with LCs included. Previous studies on the effect of corporate governance on firms' liquidity holdings are focused on the cash component of corporate liquidity (Jensen, 1986; Dittmar et al., 2003; Chen and Chuang, 2009). However, according to Sufi (2009), almost 87% of firms in his sample utilize LCs to manage their liquidity needs and LCs account for over 50% of firms' total dollar value of liquidity. These figures demonstrate the important role of LCs as an alternative source of liquidity to cash. It follows that failing to account for LCs in assessment of the effect of corporate governance on liquidity will create an incomplete picture of this effect and, thus, could lead to erroneous policy conclusions.[5] Second, we shed light on CEOs' preferences between cash and LCs and illustrate how entrenched CEOs can potentially distort the composition of liquidity against the interests of shareholders. Third, we are the first to study the effect of CEO entrenchment on the ratio of LCs scaled by assets (LC/assets). We find that this ratio increases with entrenchment, indicating that firms with an entrenched CEO increase the use of LCs, despite the fact that LCs are associated with bank monitoring.

Our findings have important implications for firms' shareholders and creditors. Excess liquidity associated with CEO entrenchment is costly for a firm in that it leads to foregone interest income, via the holding of cash, payment of additional fees to obtain LCs, and payment of interest on funds once LCs are exercised. In addition, excess liquidity heightens agency costs because it facilitates entrenched managers' use of funds for personal purposes (e.g., empire building, perquisites, and theft). Our findings highlight the importance of reducing the influence of CEO entrenchment on formulation of liquidity policy via corporate governance mechanisms such as incentive-based compensation. These mechanisms can help reduce the direct and agency costs of holding liquidity and help enhance profitability. Our results also show that entrenched CEOs have a tendency to increase liquidity via both cash holdings and LCs, even though the latter is accompanied by bank monitoring. According to our results, creditors will benefit from the distorted liquidity policy due to entrenchment because firms with an entrenched CEO hold larger liquidity bases, increasing their ability to service their debt.

The rest of the paper is organized as follows. Section 2 reviews the literature. Section 3 presents the hypotheses and section 4 describes the data and estimation procedures. Section 5 discusses the models. Section 6 describes the results and section 7 presents the robustness checks and sample disaggregation. Section 8 concludes.

2. Literature review

Extant empirical literature on corporate liquidity policy focuses mainly on the role of cash (Opler et al., 1999; Almeida et al., 2004; Faulkender and Wang, 2006). The principal result from this lit-

[4] It is notable that banks can add cancelation or repricing clauses that allow them to cancel or reprice the LC if the borrower's credit risk changes substantially. In this scenario, if the borrower's cash holding drops significantly, it will limit the firm's ability to draw down on LCs and/or to obtain new LCs, consequently restricting the total liquidity level of the firm. In this case, liquidity mix does exert an impact on the firm's capacity to undertake new projects. However, this is not a common practice. In general, LCs (loan commitments) are legal obligations of banks, and banks rarely fail to honor them (Saunders and Cornett, 2014). Indeed, LCs became a major source of liquidity during the 2007–2009 crisis, when other sources of liquidity dried up (Ivashina and Scharfstein, 2010). We thank an anonymous referee for bringing this point to our attention.

[5] For example, if we look only at the amount of cash a firm holds and ignore the LCs it has access to, we will incorrectly perceive a firm with low cash and high LCs as suffering from liquidity shortage and high default risk. Similarly, if the board of a company limits itself to the firm's cash holding, ignoring LCs, it could seriously underestimate the costs of excess liquidity and agency (e.g., personal perks, empire building) due to entrenchment. In this case, board decisions designed to counter these problems would not be on target.