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Executive compensation and the corporate spin-off decision☆

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ABSTRACT

We investigate the effect of CEO equity incentives on corporate spin-off decisions and find that CEOs with stronger equity incentives are, ceteris paribus, more likely to engage in corporate spin-offs (after correcting for potential endogeneity concerns). In addition to confirming previous findings that spin-offs are followed by positive announcement and long-run abnormal stock returns, we show that the level of the CEO's incentives matters. In particular, we find that while low incentive firms have a stronger announcement effect, high incentive firms experience better long run stock performance following spin-offs. This is consistent with the disciplining effect of spin-offs since low incentive firms are also found to have more independent boards. While a stronger board may be more influential on key corporate decisions (e.g., spin-offs), better incentive alignment leads to superior long run performance. Our results thus suggest that while stronger corporate governance may serve as a substitute mechanism for managerial equity incentives in the short run, they are in fact complementary in the long run.

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1. Introduction

Incentive alignment is a widely adopted mechanism by U.S. corporations to resolve manager–shareholder conflict. By granting restricted stock and/or stock options, firms provide equity incentives to their CEOs and other top executives in order to align their interests with those of the shareholders. Such managerial equity incentives motivate them to make decisions in the best interests of the shareholders. In this paper, we focus on how such managerial equity incentives affect the decision of firms to engage in corporate restructurings such as spin-offs. In particular, we investigate whether or not managerial equity incentives play any role in corporate spin-offs, and if so, to what extent the level of equity incentives impacts firm performance subsequent to spin-offs. This interesting question has so far not been studied in the literature.

Spin-offs differ from other modes of corporate divestitures such as equity carve-outs and asset sales. The spun-off division forms a separate legal and business entity as a new firm, with its shares distributed to the parent firm's shareholders on a pro-rata basis. The original shareholders of the parent firm thus continue to claim ownership of the combined residual income of both the remaining part of the parent firm and the newly formed spun-off firm[1]. The only difference is that now the newly formed firm has its own management team and board of directors. If the two separate entities are run more efficiently subsequent to a spin-off than the combined firm prior to the spin-off, then such restructuring is expected to enhance firm performance and create value for shareholders. A number of theoretical rationales have been proposed in the literature as to why firms engage in corporate spin-offs (e.g., Aron, 1991; Parrino, 1997; Nanda & Narayanan, 1999; Chemmanur & Yan, 2004), all of which suggest that long run performance improves following spin-offs. Consistent with these predictions, existing empirical literature (e.g., Cusatis, Miles, & Woolridge, 1993; Daley, Mehrotra, & Sivakumar, 1997; Desai & Jain, 1999; Burch & Nanda, 2003; Chemmanur, Krishnan, & Nandy, 2014; Klein & Rosenfeld, 2010) indeed provide evidence that corporate spin-offs do improve long run performance and create value for shareholders.

An interesting question is then how managerial equity incentives influence corporate spin-off decisions and performance. Given appropriate equity incentives, managers should be motivated to make spin-off decisions whenever such decisions are likely to benefit shareholders in the long run. This is because CEO equity incentives align the interests of the CEO to the stock price performance of the firm. If we think of the CEO as deriving benefits both from increases in stock price of the firm and from private control benefits, then the presence of equity incentives will ensure that the CEO puts more weight on the benefits coming from the cash flow rights associated with increases in stock price of the firm. Thus, for the same level of private benefits, if one compares a CEO with high equity incentives versus one without, it is more likely that the one with the high equity incentives will propose to do a spin-off (if such a decision is likely to benefit shareholders and the firm's stock price in the long run) than the one without it.

We therefore hypothesize that the level of managerial equity incentives prior to the spin-off has a positive impact on the decision to engage in corporate spin-offs and thereby on post spin-off performance. This is subsequently referred to as the *incentive alignment hypothesis*. Alternatively, improvements in firm performance may also arise from the disciplining effect of spin-offs on firm management as argued by Chemmanur and Yan (2004). In their setting, incumbent firm management enjoys security benefits like all other shareholders and also private benefits of control, which are lost in the event of a takeover by another management team. Thus, spin-offs discipline management by increasing the probability of a takeover by a rival management team subsequent to the spin-off. In their model, the spin-off decision is taken by the board of the combined firm[2]. Thus, one would expect that firms with more independent boards are more likely to make such decisions when it is in the

[1] Note that there is no "parent" and "subsidiary" relationship between the two entities after the spin-off. Both become independent publicly traded firms. The parent/subsidiary relationship does exist in other forms of corporate restructurings such as equity carve-outs.

[2] If security benefits arising from the spin-off outweigh the private benefits of control, then there should not be any divergence between the decision of the management and the decision of the board regarding whether or not to spin-off. However, if private benefits of management outweigh the potential increase in security benefits after the spin-off, then management are less likely