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Control benefits and CEO discipline in automatic bankruptcy auctions ☆

B. Espen Eckbo, Karin S. Thorburn*

Tuck School of Business, Dartmouth College, Hanover, NH 03755, USA

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Abstract

Swedish bankruptcy filing automatically terminates the employment of the chief executive officer (CEO) and triggers an auction of the firm. Critics of this system warn of excessive shareholder risk-shifting incentives prior to filing. We argue that private benefits of control induce managerial conservatism that may override shareholder risk-shifting incentives. By investing conservatively, the CEO increases the joint probability that the auction results in a going-concern sale and that the CEO is rehired. This uniquely implies that the rehiring probability is increasing in private control benefits, which our empirical results support. We also find that buyers in the auction screen on CEO quality. Overall, labor market discipline is dramatic, as filing CEOs suffer large income losses relative to CEOs of matched, non-bankrupt firms. Firms emerging from auction bankruptcy appear healthy as they typically go on to perform at par with industry rivals.
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*Corresponding author. Tel.: +1-603-646-2061; fax: +1-603-646-1698.

E-mail address: karin.s.thorburn@dartmouth.edu (K.S. Thorburn).

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1. Introduction

Jensen and Meckling (1976) observe that the limited-liability feature of equity provides an incentive for shareholders to substitute high-risk for low-risk projects during financial distress. In this paper, we focus on the risk-shifting incentives of managers, not just of shareholders. Risk shifting requires active participation of the chief executive officer (CEO), and we argue that the CEO may actually prefer to invest conservatively in order to protect her private benefits of control. We explore this argument in the context of bankruptcy filings in Sweden, where a filing summarily terminates managerial employment contracts and places the firm in an open auction. The hard constraint on management in this automatic auction system has caused several authors, including Aghion et al. (1992), White (1996), and Hart (2000), to warn of excessive risk shifting prior to filing. However, our empirical analysis, which explores the notion of managerial conservatism, suggests that this warning is premature.

While risk shifting may be close to a free option for shareholders of an insolvent firm, ‘‘going for broke’’ increases the chance that the CEO loses her job. Our key argument is that, when the CEO derives private benefits from control, she has an incentive to invest conservatively to hedge against unfavorable bankruptcy outcomes. These unfavorable outcomes include outright company liquidation, where the CEO position is eliminated, or reorganization as a going concern with another CEO at the helm. Conversely, by investing conservatively, the CEO increases the chance of firm survival and, hence, of being rehired by the buyer in the auction. Thus, we argue that the existence of private control benefits creates a manager–shareholder conflict of interest during severe distress, which counteracts risk shifting. Moreover, we show that this conflict arises even if the manager owns a large equity stake in the firm.

Our focus on private benefits of control and the implication for managerial conservatism complements the traditional analysis of contractual arrangements designed to regulate risk-shifting incentives. As documented in Smith and Warner (1979), contractual arrangements include debt covenants prohibiting certain forms of asset dispositions, such as merger, sale-leaseback, and asset collateralization. Risk-shifting incentives are also reduced by the use of convertible debt in the firm's capital structure [e.g., Green (1984)]. Moreover, in countries such as Sweden and the United States, the legal code to some extent requires company directors to shift their fiduciary responsibility towards bondholders when approaching bankruptcy [e.g., Gilson (1990)].

The notion that managerial incentives can produce a conservative investment policy is not new. A substantial theoretical literature shows that managerial concern with reputational capital can induce conservatism.[1] Our contribution is to associate conservatism with the existence of managerial private benefits of control, and to

[1] See, for example, Fama (1980), Harris and Holmstrom (1981), Holmstrom and Ricart I Costa (1986), Diamond (1989), Gibbons and Murphy (1992), Brander and Poitevin (1992), Hirshleifer and Thakor (1992), and Zwiebel (1995).

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