

Accepted Manuscript

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PII: S0929-1199(17)30197-9
DOI: [doi:10.1016/j.jcorpfin.2017.11.002](https://doi.org/10.1016/j.jcorpfin.2017.11.002)
Reference: CORFIN 1295
To appear in: *Journal of Corporate Finance*
Received date: 29 March 2017
Revised date: 8 August 2017
Accepted date: 8 November 2017

Please cite this article as: Jie Chen, Amedeo De Cesari, Paula Hill, Neslihan Ozkan , Initial compensation contracts for new executives and financial distress risk: An empirical investigation of UK firms. The address for the corresponding author was captured as affiliation for all authors. Please check if appropriate. Corfin(2017), doi:[10.1016/j.jcorpfin.2017.11.002](https://doi.org/10.1016/j.jcorpfin.2017.11.002)

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Initial Compensation Contracts for New Executives and Financial Distress

Risk: An Empirical Investigation of UK Firms

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This version: October 31st, 2017

First version: January 1st, 2014

Abstract: This paper analyses the effect of financial distress risk on the initial compensation contracts of new executives in the UK, where credit markets are more concentrated than in the US. We find that financial distress risk has a negative and statistically significant impact on the level of cash-based compensation and total compensation of executives, who are newly hired from either outside or inside the firm. This negative impact is accentuated in firms with a high fraction of bank debt, suggesting that banks, as creditors, provide monitoring and influence initial executive compensation packages in firms with high financial distress risk. Additionally, we find that financial distress risk has a negative and significant impact on the fraction of equity-based compensation for both externally and internally appointed executives.

Keywords: Executive compensation; financial distress risk; creditor monitoring

JEL classification: G30; G33

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