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journal homepage: www.elsevier.com/locate/jcorpfinExplicit employment contracts and CEO compensation [☆]Wei-Ling Song ^{a,b}, Kam-Ming Wan ^{c,*}^a E. J. Ourso College of Business, Louisiana State University, United States^b Wharton Financial Institutions Center, United States^c School of Accounting and Finance, The Hong Kong Polytechnic University, Hong Kong

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ABSTRACT

This study investigates the relation between the use of explicit employment agreements (EA) and CEO compensation. Overall, our findings are broadly consistent with the predictions of Klein, Crawford, and Alchian (1978) that an EA is used to induce CEOs to make firm-specific human capital investments that are vulnerable to opportunistic behavior. We determine that compensation is higher when CEOs have employment agreements that are written, longer in duration, or more explicit in terms. Additionally, such employment agreements are more likely to occur when firms have (i) externally hired CEOs, (ii) CEOs with large abnormal compensation, (iii) low investment intensity, (iv) low growth opportunities, and (v) CEOs with a short employment history with the firm.

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1. Introduction

Contracts are commonly used to facilitate economic transactions. They can take two major forms: (i) explicit contracting, which relies on a written contract enforced by third parties (e.g., courts), and (ii) implicit contracting, which relies on a verbal contract enforced by a goodwill market mechanism – the threat of losing future business should opportunistic behaviors occur.¹ The cost of using explicit contracting is usually high, as it entails costs to specify possible contingencies in written contracts, to detect violations of contract terms, and to assess damages when written contracts are violated (Baker et al., 2002; Klein and Leffler, 1981; Telser, 1980). Furthermore, written contracts are non-contractible when metering input productivities and rewards are very costly. In such cases, the assignment of residual claimant rights is a viable solution and is widely used in firms (Alchian and Demsetz, 1972).

In contrast, the cost of using implicit contracting is low because it provides the flexibility of adjusting terms to fit changing conditions. Overall, the empirical evidence suggests that implicit contracting is predominantly used in the labor market. Bull

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¹ Throughout this paper, implicit (explicit) contacts are synonymous with verbal (written) contracts.

(1987) estimated that less than 20% of the U.S. labor market is governed by explicit contracts. Gillan et al. (2009) find that the majority of S&P 500 firms in 2000 did not have explicit employment contracts with their CEOs. This finding raises the question of why certain firms deviate from this implicit contracting paradigm and choose to have explicit employment agreements.

In his 1978 seminal paper coauthored with Benjamin Klein and Robert Crawford, Armen Alchian provided insightful answers to the above question. His paper posits that explicit contracting is a solution to induce investment in value-enhancing relationship-specific assets, which could otherwise not be produced. Relationship-specific assets are unique and difficult to transfer to other usages. This specificity property generates appropriable quasi rents, which are vulnerable to opportunistic behavior (or hold-up) after the specialized asset is produced. Similarly, this hold-up concern could deter CEOs from investing in value-enhancing human capital that is highly firm specific. Explicit contracting stipulating higher-than-market future wages is a possible solution because it provides guaranteed payments to recover outlays of such investments. We test this prediction as the efficient contracting hypothesis, which suggests that compensation is higher when CEOs have explicit employment agreements (henceforth, “EA”).

Our study also analyzes two other competing, but not mutually exclusive, hypotheses that are essential to the debate of CEO pay. The managerial power hypothesis predicts that compensation is lower when CEOs have EAs (Bebchuk and Fried, 2003, 2004; Bebchuk et al., 2002). If CEO influence is a primary determinant of CEO compensation, powerful CEOs should negotiate for implicit contracts to obtain excessive compensation. Explicit contracts, particularly those with detailed terms, are not preferred because they are rigid. This rigidity increases the cost of contract rigging; powerful CEOs ex post change their (ex-ante) incentive contracts to put greater weight on performance measures that are more favorable ex-post (see, for example, Morse et al. (2011)).

The third is the insurance hypothesis, which also predicts compensation is lower when CEOs have EAs. This hypothesis shares the same intent as the efficient contracting hypothesis, except that its primary focus is CEO risk aversion. Explicit contracting reduces volatility in CEO compensation because it provides pre-specified payments to risk-averse CEOs against future contingencies. Thus, risk-averse CEOs who opt for explicit contracts are willing to accept lower compensation in exchange for a smaller fluctuation in their compensation, as discussed in Gillan et al. (2009). Because both the managerial power and insurance hypotheses predict a negative correlation between EA and CEO compensation, we formally employ a CEO power measure to separate its effect from the CEO risk aversion effect; this effect is not observable and must be inferred from the endogenous selection term in a treatment effect model.²

To test these hypotheses, we use an unbalanced panel consisting of 966 firms (or 12,513 firm-year observations) that had been or were included in the S&P500 index between 1993 and 2012. Our findings are broadly consistent with the predictions in Klein et al. (1978) and the efficient contracting hypothesis. Overall, our proxies for a contracting environment and attributes of contracting parties, such as the extent of appropriable quasi rents, the firm's anticipated growth in demand, and the firm's reputation capital, are key factors for determining CEO compensation and contract characteristics. In particular, CEO compensation is higher when their employment agreements are written, longer in duration, or more explicit in terms. In addition, such EAs are more likely to occur when firms have (i) externally hired CEOs, (ii) CEOs with large abnormal compensation, (iii) low investment intensity, (iv) low growth opportunities, and (v) CEOs with a short employment history with the firms.

Our results are robust and remain qualitatively similar after controlling for unobserved heterogeneity in firm characteristics. We use both the instrumental variable (IV) approach and the treatment effect model to estimate the effect of having explicit employment contracts on CEO compensation. Specifically, in accordance with Topel (1991) and Zhao (2013), we choose tenure and industry rival contract ratio, respectively, as our instrumental variables. Tenure is the number of years a CEO has worked in a firm, including those years prior to being a CEO. Industry rival contract ratio is the fraction of CEOs (excluding the firm of interest) that have EAs in the same industry in the same year.³ When the choice of explicit contracting is treated as an endogenous variable, we find that CEO compensation remains higher when CEOs have EAs. Furthermore, our instrumental-variable and treatment effect estimates are greater than those in firm fixed-effect models. This property implies that the true effect is underestimated due to the endogeneity concern.

Our findings also suggest that CEO influence has no power to explain the choice and characteristics of CEO employment contracts. Furthermore, CEO influence does not play a role in CEO total compensation when they have EAs. This indicates that the usage of EAs in CEO compensation is mainly driven by other fundamental economic factors. However, among CEOs without EAs, more powerful CEOs receive significantly higher total pay than less powerful CEOs. These results, taken together, offer an important resolution to the debate on CEO pay. The main message is that when CEO employment agreements are explicitly analyzed in conjunction with pay practices, we can show that the efficient contracting theory plays the most important role; higher CEO pay mainly reflects business conditions. However, this does not preclude powerful CEOs rigging their implicit contracts to a minor extent within the outrage constraint, as shown by the results within firms using implicit contracts.⁴

This paper contributes to the literature in several ways. First, this is the first study to investigate whether efficient contracting theory and CEO influence affect the choice of employment agreements and compensation practices in an integrated manner. These

² The estimates on endogenous selection control variables in the CEO total compensation regressions are significantly negative, which suggests that the “unobserved” willingness to have EAs is associated with lower CEO pay. The finding is consistent with the insurance hypothesis. However, when the endogenous selection term also reflects the unobserved CEO influence that is not fully captured by our CEO power measure, the results are also consistent with the managerial power hypothesis. Due to this inconclusive interpretation, we do not emphasize this finding.

³ In accordance with Fama and French (1997), we classify firms into 48 industries. Our results are robust to other industry classification methods, e.g., one-digit or two-digit SIC codes.

⁴ Our main results are also consistent with Wan (2014), who argues that contract rigging is not necessarily a sign of board capture in the managerial-power view. It can also be a sign of high quality incentive contracts in the efficient-contracting view. That is, regardless of CEO power, all companies may want to adjust compensation contracts ex post when unforeseen shocks alter the incentive sensitivity or introduce too much noise into the performance measures.

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