Discussion of "CEO Contractual Protection and Debt Contracting"

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Summary

- Research question:
  - Do CEO employment contracts affect debt contracting?
- Findings:
  - The presence of CEO contract protection and severance pay is associated with more frequent use of financial covenants, and higher cost of debt.
  - The above association is stronger for CEOs with longer tenure and older CEOs.
  - The above association is stronger for firms with higher growth.

Summary

- The research question is interesting.
- Empirical analyses are comprehensive and thorough.
- Some suggestions on
  - Motivation
  - Hypothesis
  - Empirical tests

Motivation

- Does this study want to shed light on the effect of CEO employment agreements on CEO risk taking?

Or

- how CEO risk preference affect debt contracting?

Or

- the accounting angel?

Motivation

- Does this study want to shed light on the effect of CEO employment agreements on CEO risk taking?

What do we know?

- CEO employment agreements increase CEO risk taking (Huang 2011; Xu 2011; and among others).

Motivation

- Does this study want to shed light on how CEO risk preference affect debt contracting?

What do we know?

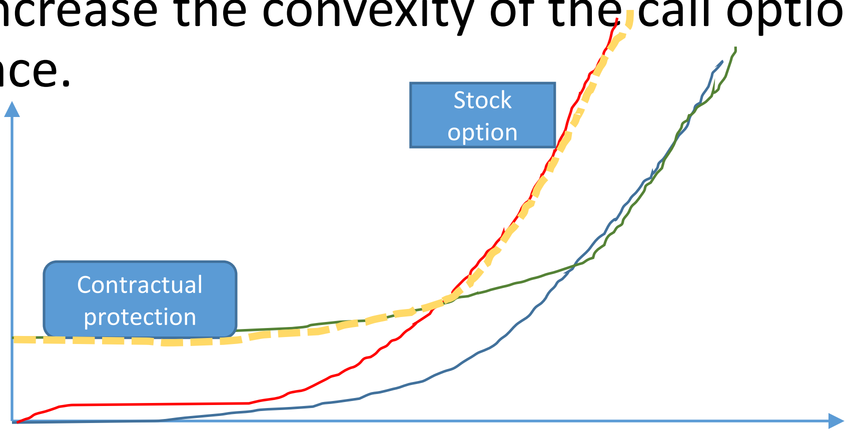
- Higher risk taking is associated with higher cost of debt (Bagnani et al. 1994; Ortiz-Molina 2006; Gong et al. 2015);
- Higher risk taking is associated with shorter debt maturity (Brockman et al. 2013);
- Higher risk taking is associated with more covenant usage (Begley and Feltham 1999; Gong et al. 2015)

Motivation - suggestions

- Clearly lay out the motivation in the first two paragraphs of the introduction.

Contribution

- Both equity incentives such as stock options and contractual protection increase the convexity of the call option, thus increasing risk preference.



Suggestion: will stock options and contractual protection reinforce each other increasing the convexity of the call option value – an interaction effect?

Empirical predictions – risk perspective

- What determines whether there is an explicit employment contract?
  - From the agent perspective:
    - Risk averse
    - Uncertainty
    - Potential loss to CEOs
  - From the principle perspective:
    - Risk neutral
    - Maximizing shareholder value
  - Principle can either pay a premium now or offer an EA to the agent.
    - Because of differences in risk preference, uncertainty or potential loss to CEOs across firms, some agents choose an EA while others do not.
    - In equilibrium, firms with higher uncertainty or higher potential loss to CEOs will likely use EA.

In sum, EA is a way to incentivize CEOs to achieve the optional risk level.

Empirical predictions-risk perspective

- I don't see why the optimal risk that maximizes shareholder value will depend on the presence of an EA in equilibrium.
- What we observe is: Risky firms likely employ EAs and these firms have higher cost of debt and more covenant protections in debt contracts.

Suggestion:

- It needs an element that there is friction for optional contracting (i.e., cost of having an EA).
- Or EA might induce excessive risk seeking (suboptimal contracting).

Empirical predictions-managerial myopia and accounting quality

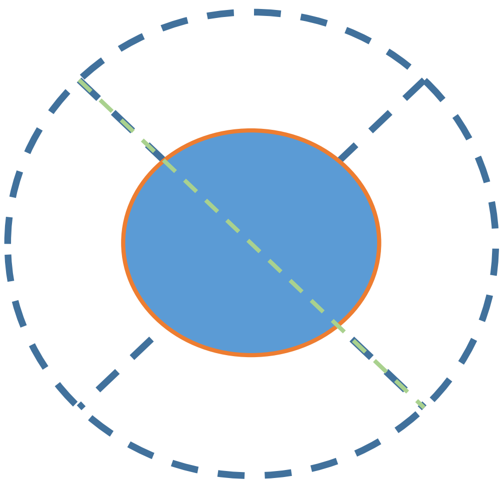
- The argument is that EAs reduce managerial myopia.
- Empirically Chen et al. (2015) find that firms with EAs have lower REM (Real Earnings Management)

Questions:

- How about accruals-based earnings management?
- Conceptually does REM reduce accounting information quality?
- Cutting R&D might reduce firm risk, which likely benefit debtholders.

Empirical predictions- real earnings management perspective

- If REM is costly, it is true for both shareholders and debtholders,
- **Then firms with an EA, which has lower REM, should have lower interest rates, particularly for <u>longer maturity debt</u>.**



Empirical predictions

- In sum, I am unclear regarding the empirical predictions from accounting information perspective.
- From risk perspective, it needs some element of frictions in the equilibrium test or some off-equilibrium analysis.

Empirical predictions- debt maturity structure

- Why focus on financial covenants and loan spread?
  - Should loan maturity structure also be considered?
- Loan maturity seems to be pertinent when we consider horizon.
- **Prediction:**
  - **If an EA exacerbates asset substitution risk, then debtholders are expected to shorten debt maturity.**

Empirical predictions- covenants

- Why focuses on financial covenants?
  - Should any covenant protect lenders?
- See Billett, King and Maurer (2005).
- **Prediction:**
  - **If an EA exacerbates asset substitution risk, then debtholders are expected to use more covenants.**

Empirical predictions- performance pricing

- Why focuses on <u>performance pricing</u>?
- What determines the use of performance pricing?
  - Renegotiation costs (Asquith et al. 2005)
  - <u>Uncertainty</u> (Roberts 2015)

- Type of performance pricing
  - Based on financial variables such as leverage or EBITA;
  - Or debt ratings.

Empirical analyses- cross-sectional analyses

- Use IV approach to estimate the model.
- Include the main effect of the cross-sectional variable (Table 6).
- Some questions on the coefficient estimate on the cross-sectional variable (Table 8):
  - The coefficient on Old_CEO or long tenure is not loaded.
  - The coefficient on growth_stage is negative in the loan spread regression, suggesting that debt holders perceive these firms to have low risk.

Empirical analyses

- Excellent empirical work
- Very comprehensive

Empirical analyses - simultaneity

- Loan contract terms are simultaneously determined.
- **It is necessary to estimate loan covenants, interest spread, and debt maturity simultaneously.**

Suggestions – Empirical analysis

- IV approach
  - Related with Chen et al. (2015), I am not sure why the effect of non-compete enforceability is negatively associated with CEO protection. I thought it will be the opposite!
  - Needs a more detailed discussion the exclusion restriction condition conceptually.
  - For example, anti-takeover provision might have impact on business uncertainty. If so, it will affect the use of EA and debt contracting simultaneously. Therefore, it violates the exclusion restriction condition.

Suggestions-alternative explanation

- CEO reputation might affect the likelihood of contracting explicitly with the board.
- CEO reputation might also affect debt contracting.
- CEO reputation might constitute a correlated omitted variable.