Agency problems and debt financing: leadership structure effects

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Abstract

In previous research, Friend and Hasbrouck theorized that managerial insiders (officers and directors) have a personal incentive to cause the firm to use less than the optimal amount of debt in its capital structure. They suggested this occurs because officers and directors have a large proportion of their personal wealth invested in the firm in the form of common stock holdings and firm-specific human capital. This makes managerial insiders reluctant to use the optimal amount of debt financing for the firm because of the additional bankruptcy risk higher levels of debt engender. I test FH’s theory and find evidence that supports it. Specifically, the amount of debt in our sample firms’ capital structures declines as the percentage of the firm’s common stock held by the CEO and other officers and directors increases. A direct relationship is found between blockholder share ownership and our sample firms’ debt/equity ratio. This suggests that monitoring by blockholders is effective in controlling the suboptimal debt usage agency problem. Further, for any given level of blockholder share ownership, the greater the number of blockholders a firm has the less effective blockholders are in raising the amount of debt in the firm’s capital structure. Lastly, some weak evidence was found suggesting that a dual leadership structure was effective in increasing the amount of debt in a firm’s capital structure.

Keywords

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