E S G I N V E S T I N G

Managerial Decision Making and Capital Structure

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This article investigates leverage influence on project selection. Does a company's obligation to commit future cash flows toward making fixed debt payments encourage its managers to make better, more prudent decisions?

We seek to answer this question by examining 428 mergers (1962–1982) and then 389 acquisitions of all types (1982–1986). Announcement-period acquirer returns are greater the higher the leverage of the acquirer. A third data set contains 173 acquisitions undertaken during 1978–1990 for firms that underwent major increases in leverage, often forced by hostile takeover.

Our work supports the argument in agency-cost theory that the debt market disciplines management. Acquisition performance increases after restructuring. The evidence is invariant with respect to methodology — beta-adjusted abnormal returns, numeraire portfolio approach and three-factor regression model residuals produce identical results. Overall, the data support the hypothesis that debt improves managerial decision-making.

There are several reasons for this. For one thing, a high debt load limits managerial discretion by forcing firms to seek external funding for new projects. For another, debtholders have different legal powers from stockholders. In the event of default, for example, debtholders have the legal standing to review managerial decisions and to have managers replaced through the courts.

eliminate the risk of experiencing investment losses.

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