

# What Motivates Managers? Evidence from Organizational Form Changes

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*We formulate and test several hypotheses on managerial motivation using organizational form changes in the real estate industry. We find that firms that switch to a more restrictive structure have increases in stock value and managerial ownership. Firms moving to a less restrictive structure have larger wealth effects when higher monitoring exists. Higher degree of financial distress and forced CEO replacement at the time of organizational form change are taken to be proxies for higher degree of (creditor) monitoring. The wealth effects are decreasing in the firm's level of free cash flow at the time of organizational form change.*

## Introduction

The modern agency literature has developed into two strands depending on the source of the managerial agency problems. An extensive literature follows Jensen and Meckling (1976), focusing on the relatively small ownership of cash flow claims by the manager as the source of distortions in managerial actions, such as excessive consumption of perks, underinvestment or shirking. A second strand emphasizes managers' private benefits of control (e.g., see Jensen, 1986; Stulz, 1990). The benefits of control are only available to the manager and cannot be contracted away to other shareholders. Examples of such control benefits are management perquisites, synergy with other firms run by the same management, returns to firm-specific investment in human capital, reputation effects arising from successfully managing the firm, etc. In general, the higher the degree of managerial discretion, the greater are the benefits of control. For example, a project or a firm with large amounts of free cash flow (Stulz, 1990) might allow large benefits of control. Control benefits create incentives for management to distort investments deviating from value-maximizing levels. The relative importance of private benefits of control and the value of their cash flow claims in motivating managers is an empirical question of central importance in corporate governance.

The purpose of our study is to examine how managers choose among the organizational forms that provide them with different degrees of discretion. Based on a careful examination of the contracts, which define the different organizational forms, we categorize changes among organizational forms into two classes; those that decrease and those that increase managerial discretion. Given this characterization of changes in organizational form that the manager initiates, we can examine the relative importance of managerial discretion and the value of their cash flow claims in motivating managers. Using a model of this trade-off between managerial discretion and the value of their cash flow claims, we formulate several testable hypotheses on changes in organizational form.

All else constant, a change into a tighter organizational form should decrease agency costs and increase overall shareholder value. However, since managerial discretion goes down with such a change, it may not be in the interest of the managers to initiate this change. If the manager holds a large fraction of equity in the firm, then the gain in the value of his cash flow claims might offset the reduction in his private benefits of control. Since changes into a tighter organizational form reduce managerial discretion and the managerial benefits of control, management would propose such changes only if they are accompanied by large increases in the value of managers' equity claims. This implies that changes to more restrictive organizational forms should be accompanied by increases in shareholder value. Moreover, such changes are more likely when the manager's ownership of equity and options are high.

Similarly, since changes into a looser organizational structure increase managerial discretion, they lead to an increase in agency cost and, hence, a reduction in shareholder value. These agency costs are aggravated by the presence of free cash flows. In the case of a healthy firm with a large amount of free cash flow and no increase in the monitoring of management, these organizational form changes are value reducing for shareholders.

On the other hand, if a distressed firm undertakes such organizational form changes, its wealth effects may be better than that of a healthy firm for the following reasons: (1) since the firm has low levels of free cash flow, the agency costs resulting from a looser organizational form would be low; (2) as the firm goes through different stages of financial distress, the extent of creditor monitoring may increase; and (3) the looser organizational form may provide additional flexibility required for restructuring the debt contract and thus reduce the cost of financial distress. These observations provide additional testable hypotheses about organizational form changes into a looser structure. Financially distressed firms that are moving into a looser organizational form should have more positive wealth effects relative to healthy firms. In general, the wealth effects of moving into a looser

organizational form should decrease in the level of free cash flow that the firm has at the time of organizational form change.

Changes into a looser organizational form accompanied by increased monitoring of managers may involve less agency cost compared to those where there is no increased monitoring of managers. One manifestation of increased managerial monitoring may be the willingness of the board to replace managers who have either performed poorly in the past or have a high taste for benefits of control. In either case, changes into looser organizational forms accompanied by managerial replacement may involve smaller agency costs than those without managerial replacement. This suggests that the organizational form changes to a looser structure should have more positive wealth effects when accompanied by managerial replacement than otherwise.

We examine a sample of 134 changes among different organizational forms in the real estate industry. We look at real estate investment trusts (REITs), which pay no taxes but accept significant restrictions on investment policy. In addition, the legally mandated requirement that the firm pay out 95% of its taxable earnings to shareholders significantly limits the free cash flow under managerial control. We also examine the traditional corporate form, which allows much greater freedom to make investment and dividend decisions but at the significant cost of double taxation. In between these two extremes, there are organizational forms, such as master limited partnerships (MLPs), and business trusts that share some characteristics with both REITs and corporations.<sup>1</sup>

An overview of our empirical results follows. We examine the announcement effect of different organizational form changes that change managerial discretion and document the degree of managerial alignment with stockholders. To examine the intensity of this alignment, we determine the percentage of stock held by insiders in the firm and the fraction of management compensation related to the stock price (primarily management warrants). Insider ownership in those firms that are moving to a tighter structure (27.81%) is significantly higher than it is in firms moving to a looser structure (10.93%). The warrant component in management compensation in firms moving to a tighter structure (23.47%) is also significantly higher relative to firms moving to a looser structure (5.71%). Since managerial discretion

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<sup>1</sup> Much of the traditional discussion of these different organizational forms emphasizes their differences in tax structure and dividend policy. For example, Moore et al. (1989) investigate MLPs formed by a total conversion of corporate assets and a rolling-out of subsets of those assets and document a significant positive announcement effect. We look at these organizational forms in the context of managerial discretion. We characterize organizational form changes by firms moving into a looser or tighter structure, i.e., increasing or decreasing managerial discretion. For example, the REIT structure, with its restriction on investment and dividend policy, curtails managerial discretion and, hence, their private benefits of control. At the other extreme, corporations, with their looser constraints on investment and dividend policy, cede more discretion to managers.

and managerial benefits of control decrease with changes into a tighter organizational form, it is the increase in the value of the cash flow claims that motivates managers to initiate such changes.

On the date the board approves an organizational form change to a tighter structure, the stock price increases by 4.71% over a Day -5 to +5 window.<sup>2</sup> The larger holding of equity-aligned claims by managers of firms that move into a tighter structure and the positive and significant wealth effects on the announcement of changes into a tighter organizational form are consistent with our hypotheses.

Changes to a looser organizational form increase managerial discretion and benefits of control. Managers could be willing to initiate such changes whether or not they are accompanied by increases in shareholder wealth. However, the value loss from managerial agency costs is smaller if the organizational form change is accompanied by increased monitoring of managers either by creditors or the board of directors.

Whether or not a firm is in financial distress provides us with a measure of the degree of control and monitoring by the creditors. Based on a number of relevant criteria, we classify the firms into those that are healthy and those that are in financial distress. To measure board monitoring, we explore whether or not stockholders exercise their right to replace the incumbent management of the firm. Among the firms moving to a looser structure, we expect to find a higher wealth effect among the financially distressed firms and the firms where managers are replaced at the time of the organizational change.

In our sample, the announcement effect of firms moving into a looser organizational form is positive and significant (2.84%). We also find that the wealth effects are larger for distressed firms moving to a looser structure (4.23%) compared to healthy firms (1.97%). The cumulative abnormal returns (CAR) during 2 years prior to the organizational change of 22.07% goes to a postchange of 3.6% for healthy firms and from -58.19% to 4.1% for distressed firms. This evidence is consistent with our hypotheses regarding increased managerial monitoring in firms going through financial distress and the value of the flexibility of the looser organizational form in mitigating financial distress cost. We also document that the wealth effects for healthy firms moving into a looser organizational structure is declining in the level of free cash flow at the time of the organizational change. This is also consistent with our hypotheses relating agency costs and free cash flow.

We compare the wealth effects of healthy firms moving to a looser organizational structure with and without replacement of the incumbent management. We find that the stock price change is more

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<sup>2</sup> The date the board approves an organizational form change is the earliest public announcement. The exact sequence of events following the board approval in which the firm's creditors and shareholders vote on the proposed change is described in Section 5.2.

positive for firms where incumbent management is replaced around the time of the organizational change. More specifically, the announcement effect 4 A. Damodaran et al. / Journal of Corporate Finance 12 (2005) 1–26 for these organizational form changes without managerial replacement of 1.14% is significantly lower than the announcement effect with managerial replacement of 7.16%. When we further categorize firms into those where the management change precedes the change in organizational form and those where it follows the change, we find that the positive excess returns are almost entirely concentrated in firms where the management is replaced prior to the organizational form change.

This paper is organized as follows. In Section 2, we provide a brief review of related literature. In Section 3, we present the institutional description of the different organizational forms along with the restrictions associated with the contracts defining the organization form. In Section 4, we also present the hypotheses and testable implications for the trade-off between managerial discretion and managerial cash flow claims determining the organizational form change. In Section 5, we describe the sample and illustrate the impact that organizational form changes have on stock price. Section 6 concludes.

## Related Literature

In a modern corporation, stockholders and other outside investors delegate decision-making authority to managers. Managers, as the agents of stockholders, are charged with making decisions that enhance the wealth of the stockholders. Although stockholders supply the capital, they have only limited influence over the corporation's activities, which are primarily under the control of the management. In the U.S., management typically owns a small fraction of the cash flow claims of the firm. The agency problems caused by this separation of ownership and control (or finance and management) and the mechanisms of corporate governance to reduce it have been the subject of extensive research that began with Berle and Means (1932).<sup>3</sup>

The theoretical and empirical literature has examined mechanisms that mitigate agency problems. These mechanisms can be broadly categorized into two classes. One class examines means to align the incentives of managers with those of stockholders.<sup>4</sup> Managerial ownership of stocks and

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<sup>3</sup> See Shleifer and Vishny (1997) and John and Senbet (1998).

<sup>4</sup> Various mechanisms have been studied that align stockholder and managerial interest, thereby mitigating agency costs (see Byrd et al., 1998 for a review of the literature). These mechanisms include equity-based devices, such as stock ownership, which tends to increase management costs of shirking and excessive asset use, although Stulz (1988) shows that problems exist if ownership is too large; incentive compensation (stock options), which shifts

options and incentive features in the managerial compensation structure that increase sensitivity of managerial wealth to firm performance (such as bonus plans and managerial dismissals for poor performance) are examples.

The second class of mechanisms involves increased monitoring of managers and the use of the additional information generated in contracting with and disciplining the manager.<sup>5</sup> The idea here is to limit the distortions arising from managerial discretion and managers' preference for private benefits of control by using contractual and disciplinary mechanisms. Examples of contractual mechanisms include managerial contracts that specify particular actions for managers, restrictive debt covenants that constrain managerial actions and organizational form contracts which reduce managerial discretion. Increased monitoring by a board (and activist large investors) or creditor monitoring (during financial distress) that lead to managerial dismissals also represent mechanisms that reduce the expected value of managerial benefits of control.

There is some empirical evidence on the value of aligning managers with shareholders. Increasing the amount of stock owned by managers is the most direct method of aligning the interest of managers with those of shareholders. A number of empirical studies of US corporations document a positive relation between managerial stock ownership and firm performance. However, the relation is not monotonic (e.g., see Morck et al., 1988, 1990; Hermalin and Weisbach, 1991; McConnell and Servaes, 1990). This evidence is consistent with that of Stulz (1988), who showed that high level of stock ownership by managers can accentuate conflicts between stockholders and managers. Managers can

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the risk preference of management toward stockholders; and punitive devices, such as firing incumbent managers. Other mechanisms that are particularly relevant to our paper is the argument of Jensen (1986) that firms with high levels of debt and dividend tend to have reduced agency costs. Although dividends tend to be discretionary, for the case of real estate investment trusts (REITs), REITs must pay out 95% of taxable income. As such, REITs must constantly go back to the capital market to finance growth.

<sup>5</sup> Prior theoretical literature has examined the structure of contracts and the associated agency problems in determining the choice of organizational forms (see Alchian, 1950; Fama and Jensen, 1983a, b). Jensen and Meckling (1976) and Fama and Jensen (1983b) emphasize the role of the control of agency problems as a major determinant of the structure of organizations. For a survey of the literature in this area, see Jensen and Smith (1985) and Barnea et al. (1985). Allen and Winton (1994) survey the design of financial contracts. Although there has been some theoretical analysis of agency considerations in organizational choice, little empirical work on the topic exists. Brickley and Dark (1987) present evidence that the cost of monitoring store managers is an important determinant of the choice between owning (operating centrally) and franchising. Other papers that determine related issues are Mayers and Smith (1981), Masulis (1987) and Karpoff and Rice (1989). Mayers and Smith examine common stock to mutual conversions in the life insurance industry based on a sample of 30 firms. Masulis examines mutual savings and loans that switch to a stock charter. Karpoff and Rice study 13 corporations established under the Alaska Native Claims Settlement Act of 1971 (ANCSA). These corporations have many organizational restrictions, the most important of which is that stock cannot be traded.

insulate themselves from the firms' monitoring and governance mechanisms and from external disciplinary forces, such as the takeover market.

In contrast, empirical evidence on the relation between managerial discretion, related managerial benefits of control and firm performance has been relatively scarce. Some important evidence exists that relates firm performance and free cash flow. For example, Lang et al. (1989) show that bidder returns on the announcement of tender offers decrease in the amount of free cash flow that the bidders have. More recently, Ang et al. (2000) find that increased creditor monitoring lowers agency costs. However, direct empirical tests relating managerial discretion and managerial decisions have been difficult because it is hard to quantify managerial discretion in specific projects. In this paper, we order the managerial discretion available in the different organizational forms and study the motivation of managers in choosing among them.

### **Institutional Background**

In this section, we describe the characteristics of real estate investment trusts, master limited partnerships, business trusts and real estate corporations.

#### *Differences between Organizational Forms*

The real estate organizational forms examined in this study differ in three major areas.

#### *Structure of Taxation (Single versus Double Taxation)*

Single taxation is a characteristic of REITs and MLPs since both are taxed at the investor level but not at the firm level. This tax benefit is given to REITs to compensate for certain investment and dividend policy restrictions to which REITs must adhere. MLPs receive single-taxation status only if they invest in certain activities, such as real estate or oil and gas. Otherwise, for tax purposes, MLPs are treated as a corporation. This tax advantage does not exist for business trusts and corporations that are taxed at both the entity level on income and at the investor level on dividends.

#### *Restrictions on Investment and Dividend Policy (More Restrictive to Less Restrictive)*

The tax code requires REITs to distribute 95% of their taxable income to shareholders, which effectively limits REITs' use of internal financing. Consequently, REITs must return to the capital markets on a regular basis, which in turn tends to impart discipline and monitoring.

The code further requires that a minimum of 75% of a REIT's gross income must come from real estate. A REIT must also be a passive investment conduit; that is, less than 30% of a REIT's income must come from the operation of real estate held less than 4 years and income from the sale of securities held less than 1 year. REITs cannot engage in active real estate operations. They cannot operate a business, develop or trade properties for sale or sell more than five properties per year. A REIT is prohibited from entering into tax-free exchanges to acquire properties. To ensure the passive nature of REITs, the tax code had required REITs to use independent contractors to manage properties. This direct management restriction was removed in the 1986 Tax Reform Act.

Although no dividend payout restrictions exist for MLPs, a high payout ratio is likely since partners are taxed regardless of whether they actually receive the income or the MLP retains it. This fact has to be weighed off against the investment opportunities of an MLP. The empirical evidence suggests that MLPs pay out a high proportion of their earnings as dividends. Although MLPs are restricted to engaging in real estate activities (or oil and gas), there are no restrictions on the nature or management of these activities. Consequently, MLPs can actively and directly engage in the real estate trade or business. There are no MLP restrictions on the number of properties that can be sold in any given year.

Business trusts and corporations have no restrictions on dividend payout and can engage in any real estate or nonreal estate activity except those prohibited in the declaration of trust or corporate charter, respectively.

#### *Managerial Discretion over Cash Flows (Less to More Managerial Discretion)*

Because of the dividend payout requirements and investment policy restrictions associated with REITs (see Jensen, 1986), managers of REITs have less discretion over how they handle their cash flows relative to other real estate organizational forms. The flexibility afforded MLP managers is greater than that given managers of REITs since the partnership agreements of most MLPs specify only minimum cash payouts and do not mandate specific payout ratios (see Moore et al., 1989). Business trusts offer even more managerial flexibility on the disposition of cash flows. This flexibility is the result of the absence of payout restrictions. However, the managers of business trusts have unlimited liability for all debts of the trust. Managers of corporations have the most control over their cash flow options since there are no payout or investment restrictions.

### *Categorizing Organizational Changes*

Based on these three dimensions, changes in organizational form are classified as moves to a looser structure or moves to a tighter structure. We classify the movement of a REIT to a business trust, a business trust to a corporation, REIT to a corporation, REIT to an MLP and a finite REIT to MLP as shifts to a looser structure. We designate a shift from a corporation to either a REIT or MLP and a change from an MLP to a REIT as moves to a tighter structure.<sup>6</sup>

Changes in organizational form change the entity-level tax status, the level of managerial discretion and the restrictions on investment and dividend policy. These changes can be mapped into either decreases or increases in managerial discretion (and hence managerial benefits of control). They can thus form the basis of some testable hypotheses that examine the trade-off between managerial discretion and compensation in motivating managers.

### **Testable Hypotheses**

The trade-off between the change in managerial discretion and the change in managerial wealth that results from bonding and monitoring are important determinants of managerial motivation to initiate such changes. In general, managers trade off the change in value from an organizational form change against the change in managerial private benefits when deciding whether to move to a tighter or looser structure. Thus, managers who initiate a move to a tighter organization structure are trading some private benefits (because of restrictions that come with a tighter structure) for an increase in the value of their holdings that comes about from making the change. The greater the latter relative to the former, the more likely it is that they will initiate such a change.

The trade-off between the private benefits of control and the value of managers' cash flow claims provides us with several testable hypotheses. Since changes into a tighter organizational form or a more intensely monitored environment reduce managerial discretion and managerial benefits of control, such changes are only viable if they are accompanied by large increases in the value of managers' equity claims. Managers are willing to initiate organizational form changes that involve a more restrictive organizational form or a more intensely monitored environment, only if the resulting reduction in managerial discretion is offset by large enough increases in the change in their wealth caused by the organizational form change. Large expected changes in managerial wealth are possible if

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<sup>6</sup> We define a finite REIT as one that is created with a finite lifetime in mind at the end of which the assets it owns are liquidated, and the cash is returned to the stockholders.

the manager's ownership of equity and the wealth effects of the organizational form change are large enough. Consequently, changes into a tighter organizational form or a more intensely monitored environment should be accompanied by a larger managerial ownership and a larger increase in equity value. This suggests the two hypotheses below:

**Hypothesis 1** (Effect of ownership). Firms with large managerial ownership of stocks and/ or options are more likely to change into a more restrictive organizational form structure.

**Hypothesis 2** (Changes into a tighter structure). Changes into a tighter organizational form should be accompanied by significant increases in equity value.

To test these hypotheses, we categorize the different organizational forms by the restrictiveness of the corresponding contracts. We are able to map each different organizational form to its associated degree of managerial discretion.

Now, consider organizational form changes where a firm moves into a looser structure. Such a move increases managerial discretion and, hence, potential agency costs. Therefore, changes only lead to an increase in firm value (and hence shareholder value) if these organizational form changes are accompanied by an increase in the degree of monitoring involved. Moving to a looser organizational form change could be accompanied by increased creditor monitoring and/or increased board monitoring of managers. The organizational form changes could also be motivated by the need for the additional flexibility required to restructure a debt contract and to reduce the cost of financial distress. Distressed firms have a higher gain in firm value due to reduced distressed costs. Moreover, distressed firms usually have a higher level of creditor monitoring, which reduces the agency costs that arise from the higher managerial discretion associated with a looser organizational form. In addition, distressed firms have lower levels of free cash flow, further decreasing the agency costs of a looser organizational form. Moreover, even among nondistressed firms, the agency costs of a looser organizational form decline in free cash flows (see Hypotheses 5 and 6 below).

An alternative to creditor monitoring is monitoring by internal mechanisms of corporate governance, which can lead to managerial turnover for poor performance. In organizational form changes that include managerial replacement, there could be increased monitoring of managers and therefore lesser agency costs resulting from a looser organizational form structure (see Hypothesis 4 below).

**Hypothesis 3** (Changes into looser structure with no change in monitoring). Organizational form changes to a looser structure should produce a negative wealth effect when the organizational form change is

not accompanied by an increase in monitoring (creditor monitoring as indicated by financial distress and board monitoring as indicated by managerial replacement).

**Hypothesis 4** (Effect of creditor monitoring). Organizational form changes to a looser structure should produce higher wealth effects for distressed firms than for nondistressed firms.

**Hypothesis 5** (Effect of board monitoring). Organizational form changes to a looser structure should produce higher wealth effects when there is managerial replacement than when there is not.

**Hypothesis 6** (Effect of free cash flow). When nondistressed firms move into a looser organizational form, the wealth effects should decrease in the level of free cash flow in the firm at the time of the organizational form change.

### **Sample Description, Methodology and Results**

We describe our sample in Section 5.1. In Section 5.2, we examine the degree of managerial alignment resulting from their compensation structure and its effect on organizational form changes. In Section 5.3, we examine the characteristics of firms (distressed or nondistressed) that move to a tighter structure and to a looser structure. We also examine the market reaction to the announcement of changes in organizational form. In Section 5.4, we further examine the wealth effects of changes in organizational form as a function of creditor and board monitoring. In Section 5.5, we consider whether changes in tax status may be driving the stock price reaction to organizational changes.

#### *Sample Description*

Our data consist of all publicly traded real estate companies that had at least one change in their organizational form during the period from January 1966 through December 1994. We also require that each company have information available on them on both the CRSP daily return and the COMPUSTAT quarterly databases for this period. A total of 134 organizational changes met these criteria.<sup>7</sup> Twenty-eight of these firms experienced more than one organizational change over our study period, first moving from a REIT to a business trust and then later shifting to a corporation.

We obtained information on organizational restructurings from various issues of Audit Realty Stock Review, REIT Factbook and Moody's Bank and Finance Manual, Volume 2. We use the Wall Street

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<sup>7</sup> Although the organizational form changes are spread over the entire 19-year period, about one-third of the changes occurred in 1975 and 1976.

Journal, 10 Ks, SEC proxy statements and/or the PR Newswire to get dates of board of trustees/directors approval and shareholder approval for changes in organizational form.

We used several criteria to classify our sample. First, we partitioned firms into nondistressed and distressed at the time of the organizational change by examining the Wall Street Journal Index for the 5-year period preceding a change in the firm's organizational structure. We classified a firm as distressed if it incurred a net loss for each of the 3 years preceding the reorganization and if it reported at least one of the following adverse events during that 3-year period:

- a) the firm was in technical default on a debt obligation;
- b) the firm was in actual default and had filed for bankruptcy protection either under Chapter 10 or 11 of the Federal Bankruptcy Act;
- c) the firm had asked banks/public debt holders to swap properties in exchange for debt forgiveness;
- d) creditors refused to renegotiate existing credit agreements that the company stated were necessary for continued solvency;
- e) the firm indicated that they would omit dividends given that they previously paid dividends; and
- f) the firm reported that its auditor had given it a qualified opinion on the firm's financial condition, e.g., going concern qualification.

Table 1  
Measures of alignment of interests at real estate firms that changed organizational form

	To a looser structure			To a tighter structure	Looser versus tighter <i>t</i> -statistics
	Distressed	Not distressed	All		
No. of firms	47	51	98	16	
Panel (1) Insider holdings average	13.14%	8.74%	10.93%	27.81%	4.60*
Median	2.86%	2.04%	2.51%	25.60%	
Panel (2) Compensation average dollar amount	\$1,777,068	\$940,854	\$1,375,519	\$3,438,931	3.30*
Percent from warrants	5.98%	5.32%	5.71%	23.47%	3.44*
Panel (3) Replacements percent of CEOs replaced	23.53%	10.20%	17.00%	4.76%	2.01*
Percent of advisors replaced	13.33%	8.82%	11.39%	0.00%	3.17*

This table summarizes data at the time of the organizational change for firms that moved from a looser to a tighter structure and for firms that moved from a tighter to a looser structure. We categorize further based on whether the firm was in financial distress at the time of the change. We obtain the data on insider holdings from the SEC filings made by insiders at these firms. We define insiders as managers, directors and any investor who holds more than a 5% interest in the firm. The table also summarizes the average dollar compensation received by the CEO in the year of the organizational change and the percent of the compensation from management warrants granted in the same year. The table also lists the percentage of CEOs and advisors who were replaced in the year of the organizational change. The data on these variables were available for only 98 of the 134 organizational changes.

\* Significant at the 0.05 level.

We define two variables to denote whether a firm is distressed or not. NDISTR is a dichotomous variable where 0 if healthy; 1 if distressed. We also define composite distress measure, CNDISTR, by adding up the events [(a) through (f)] listed above. This implies that CNDISTR can take on integer values from 0 to 6. This measure is constructed such that the larger values correspond to firms that are more distressed. Over 86% of the firms that met these criteria for distress were in actual or technical default in bond payments and were suffering severe financial difficulties. We also grouped our sample by firms moving to a looser or a tighter organizational form, as earlier in Section 3.2.

### *Management Alignment and Organizational Changes*

In Table 1, we examine three measures of managerial alignment and the choice of organizational form change (Jensen and Murphy, 1990). First, we examine the insider holdings at these companies in the year of the organizational change, using the SEC insider filings made by these firms. Second, we look at the type of management compensation contract that firms had at the time of the organizational change. We collected information on the different components of compensation in the year of the organizational change for each firm in our sample. We gathered information on the value of stock options; managers' salaries, including salaries received as board members; additional fees that insiders earned as property managers, advisers and real estate brokers and fees from other tie-in arrangements from the 8-Ks and proxy statements. Finally, we determined whether the management team itself changed at the time of the organizational change. We looked at whether the CEO or the management advisory team<sup>8</sup> used by the firm was replaced in the year of the organizational change.

Since information on all three of these variables was available for only 98 of the 134 organizational changes in our sample, we report the results for only these firms in Table 1. The CEO was replaced in 18 of the 98 firms in our sample in the year of the change. The management advisory team was replaced in nine of the 98 firms that had advisory teams in the first place.

From Table 1, we see that consistent with Hypothesis 1, firms that moved to a tighter structure have a median insider holding of 25.6% of the outstanding stock of the firm. In contrast, the median insider holdings at the firms that moved to a looser organizational form are only 2.51%. Although

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<sup>8</sup> REITs are organized either as advisor REITs or as self-advised REITs. In an advisor REIT, the advisory firm (as a separate entity distinct from the REIT) is responsible for managing the daily operations of the REIT and presenting investment opportunities to the board of directors of the REIT. There are no restrictions on who may act as a REIT adviser. Officers of the company that organized (sponsored) the REIT generally serve as officers of both the sponsor and also the advisory firm. The advisor is compensated according to an advisory contract that is typically 1 year in length. The contract is renewed annually at the discretion of the REIT's board of directors. Prior to 1986, all REITs were externally advised.

moving into a tighter structure reduces managerial discretion, managers are motivated to initiate such changes because of the favorable effect on their wealth that results from increases in the value of their large equity holdings. Since their median holdings are 25.6%, if the stock price increases when the organizational form changes to a tighter structure, the anticipated wealth increases could motivate managers to undertake such changes. Table 2 shows that increases in equity value that result from changes to a tighter structure do in fact occur.

Table 2  
Abnormal returns around organizational changes

Event day	Board approval date <sup>a</sup>				Shareholder approval date <sup>b</sup>			
	To tighter structure	To looser structure		All firms	To tighter structure	To looser structure		All firms
		Nondistressed	Distressed			Nondistressed	Distressed	
No. of firms	16	81	37	134	16	81	37	134
-5	-0.67% (-1.52)	-0.50% (-1.39)	-0.88% (1.62)	-0.62% (-1.42)	-1.94% (-1.41)	-0.02% (-0.05)	-0.69% (-1.68)	-0.35% (-1.25)
-4	0.20% (0.81)	-0.19% (-0.44)	0.27% (0.29)	-0.03% (-0.07)	0.19% (1.43)	0.27% (0.45)	0.79% (0.97)	0.38% (0.86)
-3	0.25% (0.34)	1.41% (1.16)	1.98%* (2.59)	1.48%* (2.08)	1.60% (1.61)	1.56%* (2.19)	1.28%** (1.79)	1.19%* (1.98)
-2	0.56% (0.63)	-0.37% (-1.18)	-1.17% (-0.75)	-0.52% (-1.07)	1.36% (1.45)	-0.72%** (-1.86)	-0.10% (-0.06)	-0.39% (-0.78)
-1	1.06%** (1.76)	-0.64% (-0.93)	0.52% (0.75)	-0.17% (-0.35)	-0.92% (-0.91)	-0.40% (-0.55)	0.61% (0.83)	-0.16% (-0.30)
0	1.16%** (1.89)	1.49%** (1.80)	2.61%* (2.03)	1.78%* (2.05)	0.69% (0.86)	-0.03% (-0.08)	2.53%** (1.87)	0.74% (1.60)
1	3.80% (1.38)	0.69% (1.34)	-0.24% (-0.35)	0.69% (1.54)	-0.42% (-0.89)	0.36% (0.75)	-0.44% (-0.68)	0.08% (0.22)
2	-1.19% (-0.83)	-0.50% (-0.98)	-0.17% (-0.15)	-0.46% (-1.01)	1.39% (1.68)	-0.26% (-0.52)	-1.27% (-1.35)	-0.41% (-0.99)
3	-1.50% (-1.30)	0.81% (1.03)	-0.03% (-0.07)	0.38% (0.73)	0.58% (0.44)	0.99% (1.27)	-0.30% (-0.68)	0.60% (1.13)
4	-0.76% (-1.24)	0.33% (1.25)	1.01% (1.12)	0.43% (1.15)	-0.47% (-1.43)	0.01% (0.02)	1.41% (1.17)	0.36% (1.03)
5	1.79%* (2.16)	-0.58% (-1.32)	0.33% (0.70)	-0.12% (-0.47)	-0.71% (1.12)	-0.74%** (-1.82)	-0.34% (-0.60)	-0.63% (-1.44)
-1 to 1	6.02%** (1.84)	1.54%** (1.66)	2.89%** (1.88)	2.30%** (1.86)	-0.65% (0.30)	-0.07% (0.08)	2.70%** (1.79)	0.66% (1.10)
-5 to +5	4.71%* (2.05)	1.97%** (1.82)	4.23%* (2.15)	2.84%* (2.03)	0.98% (0.91)	1.02% (0.77)	2.48%** (1.88)	1.02% (0.85)

The announcement date is Day 0 for the first event study; the date of the change is Day 0 for the second event study. We estimate excess returns relative to the market model with parameters estimated using 200 trading days, starting 220 trading days before the announcement date of the organizational change and ending 21 days before the date. We report daily returns for the 5 daily returns for the 5 days before and after the announcement day. We use cross-sectional standard errors to calculate *t*-statistics, which are reported in parentheses under the cross-sectional means.

<sup>a</sup> The board approval date is the day on which the board of directors approves of the organizational change.

<sup>b</sup> The shareholder approval date is the day on which the shareholders approve of the organizational change. It happens after the board approval.

\* Significant at 0.05 level.

\*\* Significant at 0.10 level.

In Table 1, panel 2, we present further evidence that managers of firms moving to a tighter structure trade off their managerial discretion for increased wealth effects. They tend to be paid more, and they receive a much greater proportion of their compensation from management warrants (23.47%). Thus, management experiences increased wealth effects from stock ownership. There is always the possibility that what we might be capturing in these tables is a preselection bias. For

instance, if firms with looser (tighter) structures have higher (lower) equity ownership and compensation to begin with, one would expect the results to match what we find in panel 2. To control for this, we looked at the insider ownership at all REITs and real estate corporations in 1994.<sup>9</sup> Insiders held more stock in REITs (which are tighter structures) than in real estate corporations in that year, and we believe that this pattern will hold through each year of our sample. This would suggest that preselection bias is not the explanatory factor for our findings.

In Table 1, panel 3, we find that almost a quarter of the firms, which are in distress and are moving to a looser structure, replace their CEOs. Even among healthy firms moving to a looser structure, one in 10 CEOs are replaced. It is also striking that none of the replacements are voluntary.<sup>10</sup> In contrast, there is almost no turnover at the firms that move to a tighter structure. This evidence is consistent with the view that a tighter organizational form and board monitoring of managers are alternative ways of keeping managerial discretion in check.

These findings provide some information on what motivates managers at the time of an organizational change. Firms that move to a tighter structure seem to have the greatest alignment of interests between managers and stockholders because managers have large equity ownership.<sup>11</sup> This makes shareholder wealth maximization a primary motivation for managers who are initiating organizational form changes.

For firms moving to a looser structure, the relatively low insider holdings and compensation systems unrelated to stock prices suggest that there is a significant potential for conflicts of interests between managers and stockholders. In these cases, the increased managerial discretion and, hence, their private benefits of control could be a strong component of managerial motivation.

In some cases, stockholders seem to have increased the intensity of managerial monitoring to curtail increased managerial discretion available in the looser organizational form. The managerial turnover increased by 17% at the time of the organizational change. For the subsample of distressed firms moving into a looser organizational form, increased replacement of managers can also arise from

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<sup>9</sup> The data on insider holdings were obtained from value line in that year.

<sup>10</sup> The news stories at the time of the replacement were perused for indications of whether the departure was voluntary or forced. We found that all managerial replacements are forced. We thank the referee for suggesting to check whether the managerial replacements are forced or voluntary.

<sup>11</sup> Following the referee's advice, we considered the alternate possibility that the managers in firms having a looser (tighter) organizational structure have a higher (lower) equity ownership. If this had been the case, then managers of firms moving from a looser to a tighter structure appear to have higher ownership. However, we check for this possibility directly by comparing the average insider ownership levels at REITs (tight organizational structure) and real estate corporations (loose organizational structure) in 1993. We find that the average insider holdings at REITs are significantly higher than insider holdings at real estate corporations. While this is 1 year of the sample, the results (we believe) should be general.

creditor control and monitoring.<sup>12</sup> Consistent with this, changes into a looser organizational form are accompanied by a managerial turnover of 23.53% for the subsample of distressed firms. This percentage is significantly higher than that for nondistressed firms.

### *Market Reaction to Organizational Changes*

We study the market reaction to announcements of changes in organizational form in several different ways. We examine the announcement effect for both types of organizational form changes. We also examine the announcement effect for the subsamples of distressed and nondistressed firms. For firms that move to a looser structure, we examine the announcement effects for subsamples categorized by the intensity of creditor and board monitoring. These subsamples are based on whether the firm is distressed or not at the time of organizational form change and whether or not there is managerial turnover at the time of the organizational form change.

Studying the wealth effects of these organizational form changes is important for several reasons. First, we see whether these changes convey information to financial markets about future cash flows and growth. Second and more important, we see whether these decisions create increases in shareholder value. Whether the wealth effects of the different categories of organizational form changes are positive or negative is important for interpreting managerial motivations and the trade-off between shareholder wealth and managerial discretion.

The hypothesis that we test relates this trade-off to the type of organizational form change and the concurrent change in the intensity of monitoring of managers. For example, if managerial discretion decreases for a particular subsample of organizational form changes either from moving into a tighter organizational form or because of increased monitoring by the board and/or creditors, we expect the announcement effect of the organizational form change to be positive. The resulting change in managerial wealth given the manager's equity holdings could offset the decrease in managerial discretion. If the wealth effects of a particular group of organizational form change are negative, then the management has initiated such changes only if there is an offsetting increase in private benefits of control expected from the organizational form change.

The sequence for an organizational change to a looser structure is as follows. The board approves the change in organizational form subject to receiving the necessary approvals from the firm's

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<sup>12</sup> We thank Rene' Stulz for suggesting creditor control and increased creditor monitoring as an explanatory factor for the organizational form changes among the distressed firms.

creditor banks, noteholders and shareholders. Next, the creditor banks and bondholders vote on the proposed reorganization of the firm. Finally, the shareholders vote on the proposed change.

For our sample of firms, there was not a single instance where bondholders or stockholders overruled the board of directors. If the change is to a tighter structure, only board approval is required. Therefore, information about the board's approval is the earliest announcement<sup>13</sup> of the organizational change. The stockholders' consent represents the second (and later) announcement of the same change.

To keep the analysis clean, we checked the announcements of organizational changes for other simultaneous announcements. We eliminated from the sample any announcements that were contaminated by other information.

We examine the market reaction to both events, using event-study methodology. First, we obtain the dates of the board approval and the shareholder approval of the organizational changes from the Wall Street Journal (for some of the firms in the sample, the date of board approval was not available). Second, we estimate market model parameters using 200 trading days starting 220 trading days before the announcement date of the organizational change and ending 21 days before the date. Third, we estimate abnormal returns for each trading day starting 5 days before and ending 5 days after each event.<sup>14</sup>

Fourth, we estimate the cross-sectional mean and standard error across the sample for each trading day and calculate the t-statistics. The results of the event study are summarized in Table 2 for the overall sample and for the subsamples indicated in the table.

There is a positive and statistically significant reaction to the announcements of board approvals for organizational changes for all the groups—nondistressed firms that move to either a looser or a tighter structure and distressed firms moving to a looser structure. This result holds whether we look at the day of the announcement, the immediate 3-day announcement period (Days -1 to 1) or the entire 11-day window (Days -5 to +5). There is a mixed effect following the later announcement of shareholder approval. Only troubled firms report statistically significant positive returns either on the announcement day itself or over the announcement period.

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<sup>13</sup> The earliest Wall Street Journal announcement dates for firms in our sample are all board approval dates. Thus, it can be viewed as the earliest news release relating to the organizational change.

<sup>14</sup> Although the abnormal returns reported in the tables are based on the market model, we also estimated abnormal returns without the alpha ( $R_j - h_j R_m$ ) and without adjusting for risk ( $R_j - R_m$ ). The results were similar.

Thus, the initial announcements of pending organizational changes seem to generate positive stock price reaction<sup>15</sup> whether the shift is to a tighter or a looser structure, but the later announcements of shareholder approval generate few significant price reactions. The abnormal returns around the shareholder approval date are not significant for either the whole sample or any of the groups. The wealth effects of organizational form changes for firms that move to the tighter structure are positive and significant. The wealth effects of firms that move to a looser structure are greater (4.23%) for distressed firms than for nondistressed firms (1.97%). Although the difference is in the right direction, it is only significant at the 10% level.<sup>16</sup>

The evidence indicates that stockholders anticipate, at least at the time of the organizational change, that the change will lead to higher cash flows in the future notwithstanding the private benefits accruing to managers, and that the improvement will be much greater for distressed firms than for nondistressed firms. Their expectation is largely borne out by the improvement in performance at firms that change organizational form, which is documented in Damodaran et al. (1997).

#### *Market Reaction and Intensity of Monitoring*

The evidence presented in Table 2 is consistent with managers implementing the organizational form changes to increase shareholder wealth, which in turn is a part of their compensation package. However, the positive wealth effects of changes into a looser structure warrant closer study. We know that managers increase their discretion by moving into the looser organizational structure, which can have negative wealth effects with no increase in the intensity of monitoring. As a proxy for board monitoring, we collect information on whether or not the CEO was replaced in the period around of the organizational change, which we define to be the year before and the year after. We divide the sample of firms that move to a looser organizational form into two subsamples based on whether or not there was a CEO turnover.<sup>17</sup> We then look at the stock price performance for each of the groups, using the same methodology we used in Table 2.

We would expect the wealth effects of moving to a looser organizational form to be most negative for the subgroup of firms which are not financially distressed and for which there is no

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<sup>15</sup> A potential selection bias associated with the traditional event study methodology has been explored by Malatesta and Thompson (1985), Eckbo et al. (1990) and Acharya (1988, 1993). We applied the Acharya correction to the abnormal returns and arrived at bias-adjusted returns that were slightly smaller but similar in sign and statistical significance. The bias adjusted returns are reported in Table 2.

<sup>16</sup> We use a one-sided test here given our hypothesis prediction of a higher wealth effect for the distressed subsample.

<sup>17</sup> We also analyzed firms that moved to a tighter structure. The smaller sample size and the relative homogeneity of these firms did not allow for much analysis.

managerial replacement and most positive for the firms which are financial distressed and where managers are replaced. The evidence in Table 3 is consistent with this hypothesis. Nondistressed firms with no management changes have average announcement period returns that are mildly negative in the shorter window (-1 to +1) and mildly positive in the longer window (-5 to +5).

Neither number is statistically significant. We also find that the average wealth effect for all organizational form changes to the looser structure is positive (2.47%) and significant. At the other extreme, the announcement day returns are most positive for distressed firms where the CEO is replaced, with an average excess return of 6.44% in the shorter window and 11.10% in the longer window. When we compare the wealth effects on the announcement of organizational form changes that are accompanied by managerial turnover to those without managerial turnover, we gain interesting insights. The abnormal returns are positive for both groups. However, the average for the announcement period is 7.16% for firms where the CEO is replaced, compared to only 1.14% for firms where the CEO is not replaced. This difference is statistically significant, as evidenced in the t-statistics for both the 3-day and 11-day windows. This evidence supports Hypothesis 5.

The evidence in Table 3 indicates the effect of creditor and board monitoring on the wealth effects of moving to a looser organizational form. Table 4 summarizes this evidence. Distressed firms that move to a looser organizational form and have concurrent managerial replacement could benefit from creditor and board monitoring. In this case, the increased managerial discretion associated with the looser organizational form is offset by intense monitoring by creditors and the board. Managerial ownership for this subgroup is 15.82%. The announcement effect for this subgroup of 11.1% is statistically significant.

On the other hand, nondistressed firms that move to a looser organizational form without concurrent managerial replacement have insider ownership of 7.07% and announcement effects of 0.91%. Both the managerial ownership and the wealth effects are significantly lower for this subgroup relative to the former subgroup. This evidence supports Hypothesis 3.

Nondistressed firms that move to a looser organizational form and have concurrent managerial replacement receive increased monitoring by the board but no special monitoring by creditors. For this subgroup, the announcement effect is 3.22%, and it is smaller than that for the subgroup of distressed firms with managerial replacement. Although the sample sizes are small for both groups (only 12 firms in each group), the difference is still statistically significant.

Table 3

Abnormal returns around board announcements of organizational changes into a looser form: management replacement

Event period	CEO not replaced				CEO replaced				Replaced versus not replaced
	Nondistressed	Distressed	All	Nondistressed versus distress ( <i>t</i> -statistics)	Nondistressed	Distressed	All	Nondistressed versus distress ( <i>t</i> -statistics)	
No. of firms	69	25	94		12	12	24		
-5	1.54% (1.40)	-0.49%*(2.84)	1.07% (1.35)	1.22	0.17% (0.16)	-0.43% (0.71)	-0.13% (0.22)	0.50	0.64
-4	-0.42% (1.10)	-0.02% (0.04)	0.32% (1.00)	0.70	2.15% (1.49)	1.68% (1.01)	1.92%** (1.78)	0.21	1.99*
-3	1.79%*(4.45)	0.27% (0.72)	1.39%*(2.36)	0.25	0.21% (0.51)	4.45%*(3.56)	2.33%*(2.98)	3.21*	1.12
-2	-0.67%*(2.28)	-0.34% (0.20)	-0.59% (1.19)	0.12	-0.53% (0.90)	-0.69% (0.64)	-0.61% (1.01)	0.13	0.03
-1	-0.75% (1.19)	0.29% (0.69)	0.08% (0.19)	1.54	0.58% (1.32)	1.24% (0.90)	0.91% (1.29)	0.46	1.62
0	-0.02% (0.09)	2.60%*(1.98)	0.67% (1.57)	1.62	3.49%** (1.73)	5.07*(2.88)	4.28%*(2.17)	0.34	2.54*
+1	0.61% (1.44)	-0.12% (0.18)	0.42% (1.17)	1.49	-0.79% (0.91)	0.31% (0.44)	-0.26% (0.45)	1.90**	0.99
+2	-0.31% (1.21)	-1.58% (1.57)	-0.45%*(1.98)	0.46	-3.21%** (1.89)	1.01% (1.06)	-1.10% (1.05)	2.16*	0.42
+3	0.54% (0.31)	-0.49% (1.20)	-0.40%*(1.96)	1.68**	-0.50% (1.01)	0.47% (0.90)	-0.01% (0.03)	1.35	1.61
+4	0.26% (1.60)	1.81% (1.50)	0.67%*(1.94)	1.76**	-0.47% (1.17)	0.78% (0.80)	0.15% (0.29)	1.19	0.82
+5	-0.70%*(2.25)	0.23% (0.50)	-0.45%** (1.72)	1.44	-1.04%** (1.84)	0.42% (0.53)	-0.31% (0.63)	1.51	0.25
-1 to 1	-0.18% (0.78)	2.77% (0.78)	0.61% (0.78)	1.68**	3.41% (1.63)	6.44%*(3.14)	4.93%** (1.78)	1.34	2.08*
-5 to 5	0.91% (0.95)	1.76% (0.95)	1.14% (0.95)	0.91	3.22% (0.78)	11.10%*(2.69)	7.16%*(2.42)	1.65**	2.15*

The announcement date is Day 0 for the event study. We estimate excess returns relative to the market model with parameters estimated using 200 trading days, starting 220 trading days before the announcement date of the organizational change and ending 21 days before the date. Cross-sectional standard errors are used to calculate *t*-statistics, which are reported in parentheses under the cross-sectional means. The categorization based on CEO looks at whether the CEO was replaced at the time of the organizational change. The data are available only for 118 of the 134 organizational changes in the sample.

The board approval date is the day on which the board of directors approves the organizational change.

\* Significant at 0.05 level.

\*\* Significant at 0.10 level.

These results suggest that monitoring by creditors and the board is an important factor in the overall positive wealth effects associated with changes to a looser organizational form. Taken together, the evidence indicates that a restrictive organizational form and monitoring are two alternative ways of keeping managerial discretion in check and thereby curtailing agency costs.

Table 4

Insider ownership and wealth effects for changes to a looser organizational form

	CEO replaced		CEO not replaced		All firms	
	Insider ownership (%)	Wealth effects (%)	Insider ownership (%)	Wealth effects (%)	Insider ownership (%)	Wealth effects (%)
Nondistressed firm	17.29	3.22	7.07	0.91	8.74	1.97**
Distressed firm	15.82	11.10*	11.53	1.76	13.14	4.23*
All firms	16.65	7.16*	9.42	1.14	10.93	2.31**

For the computation of wealth effects, the announcement date is Day 0 for the event study. We estimate excess returns relative to the market model with parameters estimated using 200 trading days, starting 220 trading days before the announcement date of the organizational change and ending 21 days before the date. The reported cumulative abnormal returns are computed over the -5 to +5 interval.

\* Significant at the 0.5 level.

\*\* Significant at the 0.10 level.

The announcement effect of organizational form changes into a looser form accompanied by managerial replacement is significantly larger (7.16%) than that without managerial replacement, as

evidenced in the t-statistics for both the 3-day and 11-day windows. The differences in excess returns between nondistressed and distressed firms when the CEO is not replaced are only marginally significant and only for the 3-day window. This is consistent with the monitoring hypotheses (Hypotheses 4 and 5).

The evidence regarding the effect of managerial replacement is further examined to see whether the market fully anticipates the managerial replacements that are made after the organizational form change. To do this, we categorize the firms with management changes into those where the change occurred in the year before the organizational form change and those where the change occurs in the year after the change and examine the announcement period (day -5 to +5) excess returns for the subsamples. The results are summarized in Table 5.

While both samples are small, the difference between the two groups, shown in panel (A) of Table 5, is striking. Organizational form changes to a looser structure when preceded by a change in management earn an excess return of 15.60% over the 11-day period; the returns are more positive for distressed firms (19.03%) than for healthy firms (8.25%). For those firms where the management changes occur in the year after the organizational changes, the excess returns are negative for the healthy firms and only slightly positive for the distressed firms. In short, much of the positive excess return that we see in Table 3 for the entire sample is generated by the nine firms, where an organizational form change is preceded by a management change.

Table 5  
Announcement period returns and timing of management changes

	Healthy	Distressed	All firms
<i>(A) Firms with management changes—before versus after organizational change</i>			
CEO change before	8.25% (1.56)	19.03%*(2.71)	15.60%*(3.70)
CEO change after	-4.15%*(2.29)	2.88% (0.62)	-2.55% (1.11)
CEO change before versus change after	12.40%*(3.06)	16.15%*(3.11)	18.15%*(3.59)
<i>(B) All firms: management changes before versus after or no change</i>			
CEO change before	8.25% (1.56)	19.03%*(2.71)	15.60%*(3.70)
CEO change after and no CEO change	1.40% (1.51)	1.65%** (1.68)	1.56% (1.49)
CEO change before versus no change/change after	6.85% (1.45)	18.27%*(2.80)	14.04%*(3.25)

If the management change occurs in the year before the organizational change, it is categorized as a change before. If it occurs in the year after the organizational change, it is categorized as a change after. The announcement period excess return, from day -5 to +5, is reported in the table with *t*-statistics in brackets below.

\* Significant at the 0.05 level.

\*\* Significant at the 0.10 level.

### Regression Results

In addition to the evidence presented in Tables 1–5, we also investigated the hypothesized relationships using a series of regressions of the announcement effect of organizational form changes on

proxies for the degree of monitoring, either by the creditors (as indicated by the degree of financial distress) or by the board (as indicated by the frequency of managerial replacement concurrent with the organizational form change). We also use the regressions to study how the announcement effect of moving into a looser organizational form is influenced by the level of free cash flows that the firm has at the time of the organizational form change. The precise definitions of the regression variables that we use are listed below:

- CUMRET—Cumulative returns over announcement period (Days <sub>-5</sub> to +5)
- NDISTR—0 if healthy; 1 if distressed
- CNDISTR—n, if n of the distress criteria (a) to (f) applies
- FCF—percentage of free cash flow defined as (EBITDA in year before change)/(market value of equity+value of debt)
- NCEOCHG—0 if no CEO change; 1 if CEO replaced at time of change.

Our hypotheses imply that changes into a looser organizational form would elicit wealth effects that are increasing in the intensity of monitoring by creditors or by the board and decreasing in the level of free cash flows available to management. Therefore, we examine different specifications of regressing CUMRET on the corresponding variables NDISTR (or CNDISTR), NCEOCHG and FCF (t-statistics are in brackets). While Table 5 provides us with a measure of the univariate relationships between CUMRET and the independent variables identified above, we ran multivariate regressions to examine whether the relationships above continue to hold after we control for the presence of other monitoring variables.

$$\text{CUMRET} = - .0430_{(1.11)} - .0215_{(1.52)} \text{FCF} + .1206_{(2.29)} \text{NDISTR} \quad R^2 = 21.8\%$$

$$\text{CUMRET} = - .0428_{(1.10)} - .0218_{(1.54)} \text{FCF} + .0420_{(2.26)} \text{CNDISTR} \quad R^2 = 21.8\%$$

$$\begin{aligned} \text{CUMRET} = & - .0445_{(1.14)} - .0225_{(1.58)} \text{FCF} + .1130_{(1.67)} \text{NDISTR} \\ & + .0326_{(1.27)} \text{NCEOCHG} \quad R^2 = 22.6\% \end{aligned}$$

The effect of financial distress on the wealth effects of organizational form change continues to hold when we control for the extent of free cash flow that is available to the management at the time of the organizational form change. The effect of financial distress continues to hold with reduced statistical significance when we control for the additional monitoring variable that is whether or not there is a

forced replacement of the CEO at the time of the organizational form change. The high degree of correlation between financial distress (NDISTR) and forced replacement of the CEO (NCEOCHG) which is reported in Table 6 seems to lead to a reduction in the significance of the NDISTR variable. However, given that ours is a one-tailed test, the coefficient of NDISTR, i.e., 1.67, is still significant at the 5% level.<sup>18</sup>

To explore the cumulative effect of two sources of monitoring, that is when both the firm is in financial distress, as well as when there is a forced managerial replacement, we ran the following specification:

$$\text{CUMRET} = - \underset{(0.78)}{.0167} - \underset{(0.17)}{.0586}(1 - \text{NDISTR}) * \text{FCF} \\ + \underset{(2.77)}{0.2093} \text{NCEOCHG} * \text{NDISTR} \quad R^2 = 9.1\%$$

Table 6  
Correlation matrix of three independent variables

	NDISTR	NCEOCHG	FCF
NDISTR	1.000	0.22	-0.10
NCEOCHG	0.22	1.00	0.18
FCF	-0.10	0.18	1.00

We estimate the correlations among three independent variables—NDISTR, FCF and NCEOCHG. NDISTR is a dichotomous variable to denote whether a firm is distressed or not where 0 if healthy; 1 if distressed. FCF represents the level of free cash flows that the firm has at the time of the organizational form change and is expressed as the percentage of free cash flow defined as (EBITDA in year before change)÷(market value of equity+value of debt). NCEOCHG measures whether there is a forced replacement of the CEO at the time of the organizational form change and is equal to 0 if no CEO change; 1 if CEO replaced at time of change. The correlation between NDISTR and NCEOCHG is significant at the 1% level, while the correlation with FCF is significant at the 5% level.

In this regression, the product variable NCEOCHG\*NDISTR=1 only when both types of monitoring are present. The effect of this variable on the wealth effect is significant and positive. This is also consistent with the results from Table 3 of the high wealth effects in the cases where the firm was distressed, and there was a forced replacement of the manager during the time of the organizational form change. Adding the individual variables—NDISTR and NCEOCHG—to this regression yields the following result:

<sup>18</sup> To test out the hypothesis that market capitalization would be reasonable proxy for information asymmetry, we added market capitalization to each of the regressions. Contrary to expectations, larger market cap companies have slightly more positive announcement period returns than smaller market cap companies, but the coefficient on market capitalization was only marginally significant in all the regressions. This may reflect the fact that even the largest firms in our sample would be considered small cap in the overall market.

$$\begin{aligned}
\text{CUMRET} = & 0.2806 - \underset{(0.08)}{0.0271} (1 - \text{NDISTR}) * \text{FCF} \\
& + \underset{(2.73)}{0.2809} \text{NCEOCHG} * \text{NDISTR} \\
& + \underset{(1.74)}{0.0639} \text{NDISTR} - \underset{(1.82)}{0.1294} \text{NCEOCHG} \quad R^2 = 23.5\%
\end{aligned}$$

Thus, putting the interaction effects increases the effects of NDISTR and NCEOCHG on announcement period returns. The statistical significance of both variables also increases marginally as a consequence.

To summarize, the wealth effects of organizational changes to a looser structure seems to be determined by the degree of monitoring in place after the change and the level of free cash flow available. The intensity of monitoring either by creditors or by the board restricts managerial discretion and reduces agency costs. On the other hand, the availability of free cash flow aggravates agency costs in a looser organizational structure. The evidence presented in the above regressions and earlier in Tables 2 and 3 seems consistent with such a view of the effects of managerial discretion, monitoring and free cash flow on agency costs.

#### *Taxes and Market Reaction to Organizational Changes*

There is one final confounding factor that we have to deal with in analyzing the market reaction to organizational changes and that is the change in tax status that occurs when a firm moves from being a REIT to a corporation. Since REITS are not taxed on their income, and corporations are subject to double taxation (when they pay dividends), you could argue that some of the positive reaction associated with shifting organizational form from a REIT to a corporation can be attributed to the change in tax status. We undertake two tests to determine whether the wealth effects are primarily driven by changes in the tax status.

- We categorize the organizational form changes based upon whether there is a shift in tax status (as is the case with corporation to REIT) or not (as is often the case when you shift from MLP to REIT). We find that there is no significant difference in abnormal returns between these two groups.
- We categorize firms that go from being corporations to REITs based upon whether they have taxable income at the time of the organizational change (in which case, they should be able to gain the tax benefits immediately) or reporting losses (in which case, the tax benefits should be much smaller). We find that there is no difference in abnormal returns between these groups.

The results of the preceding tests suggest that our results are not primarily driven by changes in tax status due to these organizational form changes. We believe that, even if taxes do play a role, they seem to be a relatively small part of the wealth effects in these organizational form changes.

## **Conclusions**

We study the relative importance of managerial discretion versus cash flow claims in motivating managers to initiate changes in organizational form. We formulate and test several hypotheses based on our view of what motivates managers. Organizational forms that differ in the degree of allowed managerial discretion provide us with an interesting setting to test our hypotheses on managerial motivation.

We posit that managers will move into organizational forms or a monitoring environment that restricts their discretion only when their holdings of cash flow claims is sufficiently large. In these cases, reduction in managerial discretion is offset by an increase in the value of managers' cash flow claims.

We stratify our sample of organizational changes according to whether the change is to a looser or a tighter structure, whether or not the firm is in financial distress at the time of the change in organizational form and whether or not the incumbent management is replaced when the change takes place. We study managerial ownership and the wealth effects of organizational form changes for different subsets of changes formed by our stratification.

First, we examine the characteristics of firms that move to tighter and looser structures. We examine the wealth effects at the time of board approvals of these organizational form changes. We study how the wealth effect is related to managerial ownership of stocks and warrants, the financial health of the firm, the level of free cash flow at the time of the change and whether or not management is replaced at the time of the change.

We find that the firms that move to a tighter structure have much higher insider holding and much more stock-price-based compensation. This could explain why managers at these firms are willing to accept an organizational change that gives them less discretionary power. We also show that the wealth effects of these organizational form changes are positive and significant.

Among changes to looser organizational form, we find that announcement effects are also positive. The announcement effect for distressed firms that move to a looser organizational form is somewhat larger than that of nondistressed firms. Although this difference is only marginally significant, this relation implies that the agency cost of managerial discretion in the looser organizational form is offset by increased creditor monitoring (consistent with Hypothesis 4).

Among nondistressed firms that move to a looser organizational form, we expect the agency costs of managerial discretion to be lower with lower levels of free cash flow. We expect (Hypothesis 6) the wealth effects of a change into a looser organizational form to be declining in the level of free cash flow. We regress the announcement effect on the level of free cash flow and find that the coefficient of free cash flow is negative and significant.

We examine board monitoring as another mechanism to mitigate the agency costs of managerial discretion. We show that the top management of firms moving to a looser structure is much more likely to be replaced at the time of the organizational change. We hypothesize (Hypothesis 5) that changes to a looser organizational form that are accompanied by managerial replacement will have a higher wealth effect than will changes without managerial replacement. The evidence indicates that the announcement effects of changes into a looser organizational form are positive and significantly higher than are those without managerial replacement.

In summary, we find that organizational form changes generally create wealth for stockholders but only if stockholders feel protected. Firms that switch to a tighter structure have managerial and stockholder interests aligned through substantial insider ownership and stock-based compensation systems. The wealth effects for these switches are unambiguously positive. Firms that move to a looser structure can have much greater conflicts of interests between stockholders and managers. The degree of managerial monitoring either by creditors or by the board has significant explanatory power in determining the wealth effects.

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