International Review of Accounting, Banking and Finance
Vol 2, No. 3, Fall 2010 Page 1~27

IRABF


# Corporate Governance and Risk of Default

Chia-Jane Wang [a], Jane-Raung Lin [b]

a. Manhattan College, School of Business, Riverdale, New York
b. National Chiao-Tung University, Graduate Institute of Finance, Hsinchu, Taiwan.

**Abstract:** Using 201 bankrupt and 2,751 non-bankrupt firms from the Investor Responsibility Research Center (IRRC) U.S. dataset for the period 1990-2006, we show that the rules of governance have a significant nonlinear impact on bankruptcy risk. In general, the likelihood of default is negatively related to the number of governance provisions, which allow managers to fend off challenges from shareholders. This finding supports the view that risk-averse managers prefer conservative policy choices. In addition, we find that as a greater number of governance provisions are put into place, the probability of default is decreasing but at a decreasing rate, suggesting that the larger managerial private benefits of control will reduce firm value and eventually increase the risk of default. Our findings imply that for firms with the strongest governance, a weakening of shareholder rights will decrease the probability of distress, but for firms with the weakest governance, a further weakening of shareholder rights will increase the probability of distress.

## 1. Introduction

Corporate governance has received considerable attention in recent years. Regulatory reforms in response to Enron-like governance failures concentrate heavily on board independence. However, academic research generally suggests that board structures should not be a matter of one-size-fits-all and thus mandating changes are likely ineffective and cost inefficient [see Linck, Netter and Yang (2008); Gillan and Martin (2007), and Coles, Daniel and Naveen (2008)]. The existence of a corporate board, in theory, is to solve the agency problem between diffused shareholders and management. Accordingly, the economic function of the board depends on the organizational problem it helps to address.