Managerial incentives in the presence of golden handshakes

Yi Jiang

Department of Finance, California State University, Fullerton, SGMH 5160, Fullerton, California 92831, P.O. Box 6848, United States

Abstract

This paper examines the effect of “golden handshakes” on managerial incentive compensation and risk-taking. Golden handshake, one hand, increases CEO’s pay-for-performance sensitivity by providing a high-powered incentive scheme. On the other hand, it also increases the sensitivity of CEO wealth to stock volatility, and induces CEOs to implement risky investment policy. I show the optimal incentive level increases in the presence of golden handshake. The results help to shed light on the important role of severance contract on the optimal executive compensation.

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1. Introduction

A golden handshake is a clause in an executive employee contract that provides the executive with a significant severance package at retirement or termination. It is an important component of CEO compensation. One example is Hewlett-Packard CEO Leo Apotheker, who served less than a year in his role. Despite his short stint with HP, he was entitled to nearly $14 million in severance pay. Home Depot CEO Robert Nardelli was given about $210 million in severance payout after he was let go in 2006. Promises of such comfortable landings are not unusual. Yermack (2006) finds that golden handshakes are common and lucrative. Rusticus (2006) shows that more than half of S&P 1500 firm CEOs receive ex-ante severance pay and the average amount of severance pay equals $5.9 million.

Despite the large severance payouts to executives in recent years, research has not yet conclusively determined whether severance pay is a form of rent extraction or part of an optimal contract. The empirical research has been limited and has focused on the determinants of severance pay, and its effect on CEO turnover (Rau and Xu, 2013; Goldman and Huang, 2015). The role of severance pay in executive compensation has been controversial. On the one hand, it is considered as insulating the CEO from the cost of termination (Almazan and Suarez, 2003) or implementing a kind of reward for failure to encourage managers to select more innovative and risky investment projects (Loyola and Portilla, 2014). On the other hand, it may line the pocket of managers at the expense of shareholders (Bebchuk and Fried, 2003).

In this paper I study how golden handshakes affect managerial incentive compensation and risk-taking. Two important managerial incentives are incentives to increase stock price and incentives to take risk. Given the security provided by ex-

1 Tel: +1 (657)278-4363; fax: +1 (657)278-2161. E-mail address: yjiang@fullerton.edu
2 Golden handshake is more general than golden parachute, which refers to the severance package received by CEOs whose firms are acquired (solely in the context of M&A).

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ante severance agreements, will golden handshakes decrease manager’s incentives to exert efforts? Will golden handshakes increase manager’s ability to bear risk? I study the trade-off between effort effect and risk effect. The primary research question is: will the optimal incentive level increases in the presence of golden handshakes?

Given the importance of compensation in aligning managerial incentives with shareholder interests, I first examine the impact of golden handshakes on CEO’s wealth-performance sensitivity (PPS). Using a sample of hand-collected data from 1997–2013, I find gold handshakes strengthen managerial incentives with a high-powered incentive scheme: the pay-for-performance sensitivity is increasing in the presence of golden handshakes. My results hold after I control for several firm-level characteristics, including firm size, profitability, financial leverage, return volatility, growth opportunity, CEO age, CEO tenure, as well as industry and year fixed effects.

To deepen the understanding of how golden handshakes influence executive compensation, I examine the sensitivity of CEO wealth to stock return volatility (Vega), which captures managerial risk-taking incentives. One benefit of golden handshake is that it may provide incentives to managers to implement risky projects. Managers who are not awarded severance package may hesitate to take on risky projects because if the project fails they may be fired. Further, since the manager is undiversified relative to shareholders, he will more likely avoid firm-specific risk. If severance package is granted, however, it will provide executives with insurance for their human capital and induce optimal managerial risk-taking. Consistent with this view, I find that a CEO with severance pay receives an incentive pay of greater sensitivity to stock return volatility.

As suggested by Coles, Daniel, and Naveen (2006), shareholders choose a combination of delta and vega to set the optimal incentive level. Hence the CEO wealth sensitivity to stock performance and stock volatility are jointly determined. In this case, using simultaneous equations to estimate PPS and Vega jointly could be a more appropriate approach than estimating them separately. I therefore use the three-stage least square (3SLS) approach to model a system of simultaneous equations in which PPS, Vega, investment policy, and severance pay are jointly determined. The findings support the view that golden handshakes are associated with not only higher pay-performance sensitivity but also higher sensitivity of CEO wealth to stock return volatility. Golden handshakes also mitigate the effect of CEO risk aversion and provide the CEO with increased incentives to take on risky projects.

In summary, this study contributes to the debate in the literature on the optimality of severance pay as a contracting mechanism on managerial incentives. It concludes two major findings that: (1) golden handshakes strengthens managers’ incentive to exert effort and increase their ability to bear risk; (2) shareholders enhance both CEO wealth sensitivity to stock performance and to stock volatility in corresponding compensation contracts. The remainder of the paper is organized as follows. Section 2 describes the data for empirical tests. Section 3 reports the empirical results and Section 4 concludes.

2. Data and descriptive statistics

In 2006 the Securities and Exchange Commission (SEC) revamped disclosure rules for executive and director compensation. The changes in SEC regulation require that firms disclose whether or not they provide severance compensation to their executive officers; and the amount of payments which occur if the CEO is released of duties. Taking advantage of these new disclosure requirements, I hand-collect data from firms’ disclosures on the exact amount of severance pay that a CEO would receive if he were dismissed. The sample consists of 6,274 firm-year observations between 2007 and 2013 with coverage on CRSP, Compustat, and Execucomp. Out of 6,274 observations, 3,827 observations have ex-ante severance agreements with the firm, while 2,447 do not have one. Essentially, about 61% of CEOs in my sample firms from 1997 to 2013 had a severance contract with the firm. This percentage is similar to Rau and Xu (2013). For these firms have an ex-ante severance agreement in place, the average amount of severance pay that a CEO would receive if dismissed equals $6.83 million.

Table 1 provides descriptive statistics on the features of severance agreements as well as firm and CEO characteristics. All variables are winsorized at 1% and 99%. All dollar values are in 2013 constant dollars. The average CEO in my sample is fifty-five years old and has been in office for approximately seven years. Following Jensen and Murphy (1990), pay for performance sensitivity (PPS) is the dollar value of a CEO’s wealth change per $1,000 change of shareholder wealth. Similar to Guay (1999), Vega is the change in dollar value of a CEO’s wealth per 1% change in stock return volatility. The variable PPS has a mean of $24.11 per $1,000 shareholder return and a median of $6.55. The variable Vega has a mean of $121.46 thousand and median of $79.02 thousand. Table 1 also shows that the average severance payment to be made to a CEO upon dismissal is $4.18 million. For the 3,827 firm-years with golden handshakes (the contracted severance pay is non-zero), the mean and median dollar amount of severance pay are $6.83 million and 4.11 million, respectively. The large amount of severance pay a CEO would receive if dismissed should provide him with some insurance for his human capital.

3. Empirical results

3.1. Golden handshakes and pay-for-performance sensitivity

Given the importance of compensation in aligning managerial incentives with shareholder interests, I first examine the impact of golden handshakes on CEO’s wealth-performance sensitivity (PPS). To test on the relation between golden hand-

2 Specifically, I use firms’ proxy statements (DEF-14, DEF-14A, or item 11 of Form 10-K) to collect information on severance pay.
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