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QUAECO-1041; No. of Pages 16
ARTICLE IN PRESS
The Quarterly Review of Economics and Finance xxx (2017) xxx–xxx

Contents lists available at ScienceDirect

The Quarterly Review of Economics and Finance

journal homepage: www.elsevier.com/locate/qref

Do golden parachutes matter? Evidence from firms that ultimately filed for bankruptcy

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ARTICLE INFO

Article history:
Received 16 March 2016
Received in revised form 28 March 2017
Accepted 13 May 2017
Available online xxx

JEL classification:
G33
G34

Keywords:
Golden parachute
Bankruptcy outcome
Implicit incentive
CEO compensation
Reputational capital
Corporate governance

ABSTRACT

We study bankruptcy outcomes of 275 firms and find that hiring CEOs with golden parachutes (GPs) during financial distress is associated with a lower probability of liquidation. In contrast, firms led by incumbent CEOs with GPs are more likely to be liquidated, as are firms led by new CEOs without GPs. Since GPs are nullified during bankruptcy, the observed relationship cannot be attributed to an explicit incentive effect. Rather, we contend that during financial distress GPs help recruit reputable CEOs who, even without explicit incentives, continue to maximize shareholder value due to implicit reputational and career concerns.

1. Introduction

No other tool of corporate governance receives as much media attention as does executive compensation. Instances of perceived overcompensation to executives, especially those associated with underperforming companies, stoke public outrage. This sentiment is notably stronger when underperformance is also accompanied by a golden parachute for the responsible CEO. Several academic studies have examined the benefits and costs of golden parachutes (hereafter GPs), with inconclusive results. While some studies observe higher takeover probabilities and acquisition premiums in the presence of GPs, other studies observe lower premiums for target firms with such contracts. In the same vein, several studies document a positive market response to announcements of GPs, while others document negative returns. We contribute to the literature on GPs utilizing a different perspective.

Like many others, we proffer that no governance structure, including the presence or absence of GPs, is suitable for *all* firms at *all* times because the relative costs and benefits of specific mechanisms are contingent upon the firm's unique circumstances (Dowell, Shackell, & Stewart, 2011). We study the effect of GPs in firms that ultimately filed for bankruptcy. Because bankruptcy filing renders golden parachutes null and void, such contracts lose their incentive effect on CEO behavior during the bankruptcy process. To the extent that CEO behavior can alter bankruptcy outcomes, a significant difference in outcomes between firms led by CEOs with and without GPs indicates that GPs can serve functions other than the incentive effect identified in the literature.

We contend that, when hired during distress, the presence of a GP identifies a reputable CEO who is more likely to achieve a better bankruptcy outcome. Even though GPs are nullified in bankruptcy and thus provide no explicit incentive, reputable CEOs continue to perform for shareholders because they have an *implicit* incentive to protect their reputational capital. On the contrary, the presence of a GP contract for CEOs hired outside the context of financial distress does not represent CEO quality. Such contracts have relatively smaller insurance value and thus have relatively little information content. For such incumbent CEOs, the loss of reputational capital is a foregone conclusion because the firm became distressed and ultimately bankrupt under their watch.

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http://dx.doi.org/10.1016/j.qref.2017.05.002
1062-9769/

Please cite this article in press as: Maskara, P. K., & Miller, L.S. Do golden parachutes matter? Evidence from firms that ultimately filed for bankruptcy. *The Quarterly Review of Economics and Finance* (2017), http://dx.doi.org/10.1016/j.qref.2017.05.002

Consistent with our hypotheses, we find that when a firm recruits a new CEO during times of financial distress (defined as within a year of bankruptcy filing but not less than 30 days before) and the compensation contract includes a GP, the firm is more likely to experience a favorable bankruptcy outcome. Notably, this finding is more apparent for *outside* hires than promotions from within. When hired during normal times, CEOs with GPs are no more likely to lead the firm to better bankruptcy outcomes than those hired without. If anything, a positive outcome is *less* likely. This suggests that, in the context of financial distress, the presence of a GP contract presents meaningful information, and this information content is greater when the CEO is hired from outside the firm.

To further explore the validity of our contention, we interview eight CEOs from our data sample *ex post*. Information gleaned from our conversations suggests that troubled firms pose unique challenges and risks for CEOs, which are often outside their control. Reputable CEOs do consider golden parachutes an integral part of the compensation package and use them to manage personal risk exposure. They care immensely about their reputations because the next job depends on it. We find the stories of our interviewees lend credibility to our arguments. Further support is offered by the language of the corporate filings that serve as the data source for our GP observations. An example is the following excerpt from a Form 10-K filed by one of our sample firms:

We have entered into severance and/or non-solicitation agreements with each of our named executive offers, which provide specified severance benefits in the event the officer is terminated without cause or resigns for good reason within one year after a change in control of the company. We recognize the importance of reducing the risk that personal concerns could influence executive officers considering strategic opportunities that may include a change in control of the company. We believe that the severance arrangements appropriately balance the cost to the company relative to the potential damage from distraction or loss of key executives in connection with a transaction that could benefit our shareholders.

Prior research shows that shareholders benefit from GPs when a firm is acquired. Given that GPs have no explicit costs (are not triggered) outside such situations, we would reasonably expect GPs to be a popular contract feature. However, for our sample firms, we observe that only about half of the CEOs hired during times of distress have GPs. The literature suggests some potential explanations for this intriguing finding. If the board holds an optimistic view of the firm's future, it may have little interest in being acquired even at a substantial premium over the currently depressed market price. Alternatively, the board may fear that a GP could encourage the CEO to shirk because GPs offer CEOs protection from the discipline imposed by the takeover market. Since firms in distress are prime takeover targets, a GP might actually incentivize the CEO to maintain the status quo of the distressed firm (i.e., wait for an acquisition) rather than actively seek to improve the firm's financial condition. We consider the possibility that such concerns are exaggerated. During times of distress, GPs may also serve a positive role in identifying and attracting reputable CEOs that are more likely to serve shareholders' interests due to reputational and career concerns.

2. Background

Corporate mergers and takeovers are favorable events for the target firm's shareholders, but managers of acquired firms often suffer loss of employment and diminished prospects for future employment (Hartzell, Ofek, & Yermack, 2004). Thus, the conflict of interest between managers and shareholders is enhanced when a firm becomes a takeover target. Since corporate governance measures become more important when agency problems are magnified, the corporate world has devised a governance tool precisely to address this situation—the golden parachute.

2.1. Golden parachutes

Golden parachutes are a specific type of managerial compensation that takes effect upon a change in control of the firm, such as a merger or acquisition. They are severance agreements adopted by boards of directors, with or without shareholder approval, that provide various cash and non-cash benefits to senior executives if certain events occur following a change in control (Brusa, Lee, & Shook, 2009). Examples of such events include firings or demotions of executives. Although the term "golden parachute" implies a distinct form of contract, such contracts can vary substantially along several dimensions (Fiss, Kennedy, & Davis, 2012). Some include only a lump-sum payment (often three years' salary, due to tax regulations[1]), while others extend to stock grants, options, health insurance, pension plans, consultancy arrangements, and even use of the corporate jet. These severance contracts are designed to protect CEOs from the personal costs that takeovers can impose, so they will not resist wealth-maximizing takeover attempts. Post-acquisition dismissal is a valid threat to CEOs because dismissals following a change in control are often unrelated to performance (Kidder & Buchholtz, 2002). Moreover, personal costs of displacement are significant, including loss of compensation and diminished reputation (Jensen, 1988). By offering compensation that is contingent upon a change in control, GPs can reduce the risk faced by CEOs.

Despite this seemingly rational explanation, GPs are often perceived as an example of excessive executive compensation because they award senior management with large payouts in situations where other stakeholders, such as employees, suffer negative consequences. GPs are also negatively characterized as indicators of managerial entrenchment. The entrenchment hypothesis, introduced by Manne (1965) and further developed by Shleifer and Vishny (1989), conjectures that GPs have the adverse effect of increasing slack on the part of managers as a result of being less subject to discipline by the market for corporate control. This insulation may impair shareholder wealth if: a) the manager administers the firm less efficiently due to the reduction in potential loss from a change in control; or b) the GP increases the cost of a takeover, thus lowering the takeover premium that a bidder is willing to pay (Hall & Anderson, 1997). Moreover, since GPs can be granted by boards without shareholder approval, their adoption may signal that managers hold a high level of influence over the board (Brusa et al., 2009).

Existing research on the value of GPs can be categorized into two broad streams. The first stream attempts to capture investors' perception of value by examining stock price reaction to announcements of GPs. Lambert and Larcker (1985) report a positive market reaction in support of the incentive alignment hypothesis, which posits that GPs create value by aligning the incentives of managers and shareholders. However, Jensen (1988) notes there is no way to know whether these findings reflect investors' belief in the efficacy of GPs or their reaction to a signal that adopting firms may become future takeover targets. In contrast, later studies (e.g., Bebchuk, Cohen, & Wang, 2014; Brusa et al., 2009; Hall & Anderson, 1997) observe a negative reaction for firms adopting GPs, as predicted by the entrenchment hypothesis. Other studies (e.g., Born, Trahan, &

[1] Pursuant to Section 280G of the Internal Revenue Code, golden parachute payments that exceed three times the individual's average taxable compensation over the five preceding calendar years result in: 1) loss of tax deductions to the company for any excess amount; and 2) a 20% excise tax liability to the individual on such amount.