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The totality of change-in-control payments☆

David Offenberg *, Micah S. Officer [1]

Loyola Marymount University, College of Business Administration, Hilton Center for Business, 1 LMU Drive, Los Angeles, CA 90045-2659, United States

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ABSTRACT

Most extant studies consider golden parachutes as the totality of change-in-control payments. However, for the median CEO of firms listed in the S&P SmallCap 600 index in 2009, golden parachute payments are only 46% of total change-in-control compensation. We measure total change-in-control payments using newly available data for this sample. Our results show that the total payments to the departing CEO are estimated at 1.1% of market value (on average). We also show that newly earned compensation (as opposed to accelerated vesting of lagged incentive pay) makes up approximately half of total change-in-control payments for the median CEO, and these two components of severance pay are positively correlated (contrary to existing theory). Furthermore, change-in-control payments do not appear to impede takeover offers or affect takeover premiums. Total change-in-control payments are small on average, and boards seem to take care in negotiating these terms with incumbent CEOs so that change-in-control payments do not adversely affect the firm's prospects in the takeover market.

> "Accelerated equity awards along with substantial pensions and other deferred compensation all but guarantee significant payouts at many of America's largest corporations in every termination situation…"[2]

1. Introduction

It is important that market participants understand the size of potential change-in-control payments promised to top executives at listed firms. In a 2007 article in the New York Times, the principal in charge of the executive compensation practice at Deloitte Consulting, Michael S. Kesner, claimed that "… he has seen (tax) gross-up payments sometimes reach 8% of the total cost of a

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* Correspondence author: Tel.: +1 310 338 2903.
E-mail addresses: doffenberg@lmu.edu (D. Offenberg), micah.officer@lmu.edu (M.S. Officer).
[1] Tel.: +1 310 338 7658.

[2] From "Twenty-One U.S. CEOs with Golden Parachutes of More Than $100 m," GMI Ratings, January 2012.

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merger."[3] We currently have only a weak grasp of the total size of promised change-in-control payments and the extent of their potential to harm shareholder wealth in a takeover. The existing academic literature on change-in-control payments is almost exclusively focused on traditional golden parachutes paid to departing target CEOs (cash awards, usually as a fixed multiple of the CEO's final salary and bonus), ignoring other potentially important forms of change-in-control payments.

Until recently, outsiders have had scant detail of several important components of change-in-control payments promised to CEOs: accelerated vesting of stock options and restricted stock, tax gross-ups, and accelerated vesting of performance awards.[4] For the median target CEO in our sample, a golden parachute represents only 46% of the value of benefits expected to be conferred upon the executive following termination related to an acquisition. This suggests that the existing literature overlooks a majority of these critical and criticized change-in-control payments to executives.

In this paper, we take advantage of amendments to SEC disclosure requirements enacted in 2006 to document for the first time the size of total change-in-control payments to target executives, not just golden parachutes. Further, we study the composition of total change-in-control payments, their division between newly earned compensation and accelerated vesting of past (but not already vested) incentive pay, the correlation between those components, and the effect that the size of these payments appears to have on the takeover market.

Before recent changes in mandatory disclosures, it was not possible to assess total change-in-control payments promised to managers upon a change in control because firms were not required to explicitly disclose the dollar amounts that would be paid. In 2006, the SEC mandated that companies listed in the United States divulge the dollar amount and form of such potential payments in annual filings (SEC release number 33-8732a). Listed firms are now required to detail in each year's proxy statement all potential payments they would make to their CEOs and other named executive officers upon a successful takeover. Such change-in-control payments include the golden parachute as well as tax gross-ups, pension adjustments, other benefits (such as outplacement services), and accelerated vesting of equity and other performance awards.[5]

We focus on double-trigger change-in-control payments, those where the CEO only receives the contracted amount if the firm both experiences a change in control and terminates the CEO's employment (as opposed to payments with only a single trigger, the change of control). Double-trigger payments are always as large as or larger than payments requiring a single trigger, and therefore, of most interest to target shareholders and financial economists.[6]

If the bulk of change-in-control payments is simply accelerated vesting of historic incentive pay, then that may indicate that change-in-control payments are not carefully negotiated by firms and that variation in golden parachutes may not be as meaningful as intimated in the existing literature. This is not what we find. Instead, for a sample of 447 firms listed in the S&P SmallCap 600 index in 2009, newly earned severance compensation that is unrelated to past incentive pay represents approximately half of the average total double trigger payments promised to CEOs. On average, about 75% of that newly earned compensation is the golden parachute that is the focus of much of the existing literature. Therefore, this paper makes two important contributions to the literature: documenting that the majority of change-in-control payments are newly earned and not simply the accelerated vesting of historical incentive pay, and showing that about one quarter (on average) of that presumably-carefully-negotiated newly earned CEO compensation is in forms other than a golden parachute.

In our sample, the average total change-in-control termination payment promised to the CEO is 1.1% of the market capitalization of equity. While there is some variance in the distribution, the vast majority (95%) of firms have change-in-control payments below 3% of the value of their common stock. Exploring the data further, we also find that the components of change-in-control payments, newly earned compensation and lagged incentive pay, are positively correlated. This suggests that severance compensation promised to the CEO is a compliment to regular incentive pay, as discussed in the theoretical model in Almazan and Suarez (2003). Almazan and Suarez (2003) consider the use of severance pay as a method of limiting costly incentive pay when signals about CEO performance are noisy. In particular, they view severance pay as an optimal device to moderate opportunistic behavior by either the CEO or the board.

In Almazan and Suarez's (2003) model, however, incentive compensation and severance pay are only compliments in firms with "weak" boards (and therefore entrenched CEOs; see p.529 or Proposition 6 in that paper). We measure board strength with three proxies: percent of outsiders, board size, and CEO-Chair duality. When we split our sample using our proxies for the strength of the board we find that severance pay and lagged incentive compensation are always significantly positively correlated in our sample — they always appear to be compliments. This suggests that either these standard proxies for board strength are unable to indicate firms for which the board has weak bargaining power against the CEO as envisioned in Almazan and Suarez's (2003) model, or that the model's predictions are not borne out in the data (potentially because, in reality, already entrenched CEOs can influence the firm's governance structure to begin with: see the discussion on p.538 of that paper). This result may also suggest that the CEOs in our sample are entrenched, and able to extract higher incentive and severance pay on average.

We further examine whether the change-in-control payments promised to CEOs actually deter takeovers, as critics allege. Because of the nature of our hand-gathered data (for a sample of firms from one year, and for which only a fraction are eventually acquired), our conclusions are somewhat limited. However, we find that firms that are eventually acquired have promised CEO change-in-control payments that are statistically indistinguishable from those firms that do not become targets (both approximately 1% of the

[3] "The C.E.O.'s Parachute Cost What?" Gretchen Morgenson, Business, *New York Times*, February 4, 2007. A tax gross-up is an additional payment to the executive to cover taxes due.

[4] See Elkinawy and Offenberg (2013) for more information about accelerated vesting.

[5] The payments documented in this study are based on the (hypothetical) payments disclosed by firms in their annual proxy statement pursuant to the aforementioned SEC rule change, not the actual payments made ex post (in takeovers). The disclosures that form the basis for our data do not list actual payments to CEOs but rather the payments that would be due if a change-in-control occurred at the end of the relevant reporting period.

[6] For brevity, we also refer to change-in-control termination payments as "double-trigger payments."