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Entrenchment or incentive? CEO employment contracts and acquisition decisions

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ABSTRACT

A long-standing controversy is whether CEO employment contracts insulate inferior managers from discipline leading to shareholder wealth destruction, or whether contracts alleviate managerial risk aversion and encourage value-enhancing decisions. Using a unique dataset on S&P 500 CEO employment contracts during 1993–2005, I find that acquirers with a CEO contract obtain better announcement returns, pay lower premiums for their targets, garner superior long-run post-acquisition operating performance, and undertake riskier deals than acquirers without a contract. Further investigation of individual contract provisions reveals substantial heterogeneity. Specifically, the fixed term rather than at will contract, longer contract duration, long-term equity incentives, accelerated stock and option vesting provisions in severance arrangement, and more refined definitions of just cause (good reason) for CEO termination (resignation) alleviate managerial risk aversion, reduce contracting ambiguity, and motivate value-creating decisions.

1. Introduction

This paper examines the impact of acquiring CEO employment contracts and their provisions on acquirer value creation and risk-taking. A typical CEO employment contract is usually entered into at the time of the CEO's appointment and can cover various relationships, including responsibilities of the CEO, term of employment, basic compensation arrangement, change in control provisions, and severance package. This contract can protect a CEO in several ways. First, CEO employment contracts usually fix the minimum annual salary and bonus and stipulate that they are subject to reviews for increases but not decreases, inherently reducing the sensitivity of pay to performance.[1] Second, a contract makes it more costly for a CEO to be fired, thereby enhancing her job security. Third, even in cases where CEOs are replaced involuntarily due to underperformance, managers with a contract have more bargaining power and are often compensated more generously.[2] Shareholder activists have thus criticized CEO contracts as pay for failure (Bebchuk and Fried, 2003, 2004).

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[1] The employment contract between Sprint Nextel and its CEO Mr. Gary Forsee states "Mr. Forsee is contractually entitled to an annual base salary of $1,400,000, subject to annual review for possible increase (but not decrease), and an annual short-term incentive target opportunity of not less than 170% of base salary", (Sprint Nextel Corp. Proxy Statement, 3/17/2006).

[2] For instance, Carly Fiorina was ousted by the HP board with an exit pay of $21 million under her employment pact. Hank McKinnell, former CEO and Chairman of Pfizer, was ousted in July 2006 with $200 million pursuant to his employment contract, despite the substantial underperformance of Pfizer relative to its industry peers and the market (*Business Week*, 12/22/2006). In comparison, Jeffrey Greenberg, former Chairman and CEO of Marsh & McLennan, quit his job in October, 2004 among the bid-rigging scandal with no lucrative severance package due to "the lack of an employment contract and hence the weak bargaining power" (*The Wall Street Journal*, 10/26/2004).

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Despite these costs, the percentage of S&P 500 CEOs with an employment contract has increased from 29% in 1990 to 50% in 2005. The benefits of CEO contracts to shareholders include helping attract and retain managerial talent, providing a commitment and protection from the opportunistic behavior of the board, clarifying the responsibilities and legal obligations, and resolving uncertainty about how the contractual relationship may be terminated (Hale et al., 2000; Gillan et al., 2009). Indeed, financial theories have long recognized that CEO compensation contracts can align managerial interests with shareholders (e.g., Jensen and Meckling, 1976; Jensen and Murphy, 1990). To the extent that managers are more risk-averse than shareholders, employment contracts can protect managers against downside risk and encourage value-enhancing but risky decisions the manager might otherwise avoid (Almazan and Suarez, 2003; Ju et al., 2004).

In light of these controversies, the purpose of this paper is to examine whether and how CEO employment contracts and their individual provisions *ex ante* affect a CEO's investment choices and firm's future performance. Anecdotal evidence suggests that CEO contracts may have substantial influence on managerial decision-making. John Antioco, former CEO and Chairman of Blockbuster, was ousted in a proxy fight in May 2005 but was reappointed two days later. Under his employment contract, Mr. Antioco would have been entitled to $54 million if he left the company after losing his board seat. The dissidents backed the reappointment because they did not want Mr. Antioco to "walk away with $54 million", whereas Mr. Antioco wanted more time to show the desired results of "some bold [business] moves" he undertook.[3]

Obviously, Mr. Antioco's employment contract helped secure his job and allowed him more time for the potential profits of his risky strategies to emerge. This suggests the *incentive effect hypothesis*, which predicts that by providing insurance on the down side, contracts help mitigate managerial risk aversion and motivate risky value-increasing projects. Such projects might be otherwise forgone, particularly because current earnings might be reduced, or managers initiating the projects might have been fired before the outcome materializes (Almazan and Suarez, 2003; Ju et al., 2004; Narayanan, 1985).

Alternatively, perhaps Mr. Antioco's contract prevented him from being fired due to his poor management of the business. This possibility suggests the *entrenchment effect hypothesis*,[4] which predicts that contracts insulate CEOs from discipline of the market for corporate control and internal governance, thereby lowering the costs to managers of making value-destroying investments in pursuit of private benefits. Bertrand and Mullainathan (2003) and Atanassov (forthcoming) suggest that managers under reduced discipline prefer a quiet life and avoid risk.

This paper focuses on mergers and acquisitions (M&A), which are among the most important and high profile corporate investments. Unlike internal research and development (R&D) or capital expenditures, M&A create large value impacts that are easily observable to outsiders. M&A are also associated with greater uncertainty and agency problems, thus offering an ideal setting to examine the efficacy of CEO contracts in managerial incentive alignment, which may not be revealed by studying routine internal investments only.[5]

Using a unique and manually compiled dataset on CEO employment contracts, I find that among the 577 large acquisitions made by S&P 500 CEOs between 1993 and 2005, slightly more than half of the acquirer CEOs have a contract. Consistent with Gillan et al. (2009), a CEO contract is more likely when the firm is more susceptible to takeovers or has recently underperformed, when the CEO has less power, less experience, and larger uncertainty about her capability, and when board monitoring is more effective, suggesting that contracts provide insurance for managerial human capital or protection against opportunistic behavior of the board.

Consistent with the incentive effect hypothesis, CEO contracts lead to value-enhancing acquisitions. Acquirers with a CEO contract outperform their counterparts without one by 1.3% in a three-day window around deal announcement, which translates into shareholder gains of $183 million for an average sized bidder. Acquirers with CEO contracts pay lower target premiums, thus generating large savings ($317 million) for acquirer shareholders. Further, contracts motivate managers to pursue better deals with greater profitability as measured by long-run post-acquisition operating performance.

Contracts also motivate managers toward riskier deals. Specifically, CEOs with a contract are more drawn to targets with larger pre-event stock return volatilities, recent underperformance and more growth opportunities. Subsequently, these acquirers exhibit greater increases in firm risk. Taken together, the evidence suggests that by protecting managers against downside risk ex post, CEO contracts ex ante mitigate managerial risk aversion and motivate risky value-increasing investments.

An investigation of individual provisions of CEO contracts reveals substantial heterogeneity. I find that definite term rather than at will contract, longer contract duration, long-term equity incentives in annual compensation, and accelerated stock and option vesting provisions in severance package are associated with larger acquirer value creation. This is consistent with the hypothesis that fixed term and longer duration provide greater protection to managers, thereby motivating long-term, risky, value-creating investments (Narayanan, 1985). It is also consistent with the classic view that equity incentives help align

[3] While Mr. Antioco intended to invest in long-run innovative projects, the dissidents led by Carl Icahn wanted bigger dividends (*The Wall Street Journal*, 5/16/2005, A3).

[4] This paper does not ask how an incumbent manager should position herself to be irreplaceable to achieve certain private benefits, i.e., the *process* of entrenchment. Rather it asks once an employment contract is in place, whether and how such a contract *subsequently* affects managerial incentives by making her difficult and costly to replace, i.e., the *effect* of entrenchment due to a contract. I account for the motivations of a contract to address endogeneity.

[5] Harford and Li (2007) show that following acquisitions, but not large capital expenditure, a CEO's wealth becomes insensitive to negative but remains sensitive to positive stock performance. Grinstein and Hribar (2003) find that CEOs are richly rewarded for just completing M&A and that M&A bonus is positively related to deal size but not deal performance, which is hardly the case for internal expenditures. Yermack (2006a) indicates that understanding top management incentives requires looking beyond routine activity and examining one-time events.