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Golden Parachutes and the Wealth of Shareholders ☆

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ABSTRACT

Golden parachutes (GPs) have attracted substantial attention from investors and public officials for more than two decades. We find that GPs are associated with higher expected acquisition premiums and that this association is at least partly due to the effect of GPs on executive incentives. However, we also find that firms that adopt GPs experience negative abnormal stock returns both during and subsequent to the period surrounding their adoption. This finding raises the possibility that even though GPs facilitate some value-increasing acquisitions, they do have, on average, an overall negative effect on shareholder wealth; this effect could be due to GPs weakening the force of the market for control and thereby increasing managerial slack, and/or to GPs making it attractive for executives to go along with some value-decreasing acquisitions that do not serve shareholders' long-term interests. Our findings have significant implications for ongoing debates on GPs and suggest the need for additional work identifying the types of GPs that drive the identified correlation between GPs and reduced shareholder value.

1. Introduction

Golden parachutes (GPs) became common in the late 1970s and early 1980s in the midst of unprecedented takeover activity, and they have attracted much debate and substantial attention from investors and public officials ever since. In 1984, Congress enacted Sections 280G and 4999 of the Internal Revenue Code, which seek to discourage GPs with high monetary value by imposing substantial tax penalties on their use. Over the past 15 years, precatory resolutions opposing GPs have been brought in significant numbers and have generally passed. The 2010 Dodd–Frank Act mandated advisory shareholder votes on all future adoptions of GPs by public firms.

In this paper, we contribute to the ongoing debate about GPs by using a long panel dataset from 1990 to 2007 to empirically assess the effects of GPs. We show that even though GPs are associated with higher expected acquisition premiums, they could reduce the value overall for shareholders.

The first part of our paper focuses on the effect of GPs on unconditional expected acquisition premiums (i.e., expected premiums), which is a product of the likelihood of an acquisition and the premiums that are conditional on an acquisition. There

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is a substantial empirical literature examining how GPs are associated with the likelihood of an acquisition and with premiums in the event of an acquisition (see, most recently, Fich et al., forthcoming; Sokolyk, 2011).[1] Our work, however, is the first to provide an integrated analysis combining the effects of GPs on both acquisition likelihood and premiums. We find that GPs are associated with higher expected acquisition premiums; even though GPs are associated with lower premiums in the event of an acquisition, their association with a higher acquisition likelihood turns out to dominate the lower premium effect.[2]

Furthermore, we add to the literature by showing that the positive associations between GPs with higher acquisition likelihood and higher expected premiums are not wholly due to the "private information," or signaling explanation (Lambert and Larcker, 1985), which argues that GPs are adopted when managers have private information indicating a high likelihood of acquisition. Instead, our findings show that these positive associations are at least partly driven by the effect of GPs on executives' incentives, under which acquisitions become more attractive to managers (Jensen, 1988; Kahan and Rock, 2002; Lambert and Larcker, 1985).[3] If these associations were solely driven by the signaling explanation, we would expect them to be driven by "fresh" GPs (i.e., GPs that were recently adopted). We find, however, that both "fresh" and "older" GPs are positively and significantly associated (with similar magnitudes) with acquisition likelihood as well as with unconditional expected premiums. These findings are thus consistent with the possibility that the positive associations between GPs and both acquisition likelihood and expected premiums are at least partially due to the effect on executives' incentives.

The second part of our paper, which provides the paper's most important contribution, assesses the overall effect of GPs by examining the evolution stock prices prior to, around, and after the adoption of GPs. Bebchuk et al. (2009) note that GPs are negatively correlated with firm value, but they do not identify the extent to which this association is driven by a selection effect (a tendency of low-value firms to have GPs) and/or by post-adoption changes. Focusing on stock returns over time enables us to examine the overall impact of GPs on shareholder value by combining the effects through takeover premium channels and stand-alone value channels.

We show that firms tend to experience erosion in shareholder value prior to GP adoption and that this erosion continues around and subsequent to GP adoption. In particular, we find that (i) among firms that do not have GPs, those that adopt them by the next Investor Responsibility Research Center (IRRC) volume experience lower abnormal stock returns during the intervolume period (i.e., the period between two consecutive IRRC volumes) than firms that do not adopt them by the next IRRC volume, (ii) firms that adopt GPs and maintain them in the long run experience lower abnormal stock returns following adoptions than firms that do not have GPs and do not adopt them subsequently, and (iii) the post-adoption negative abnormal returns persist even when we include the acquisition premiums earned by the acquired firms.

The findings on the erosion of shareholder value following GP adoption could be at least partly driven by a "managerial slack" effect: such an effect can occur with a weakening of the discipline of the market for corporate control (Gompers et al., 2003; Shleifer and Vishny, 1989), and GPs weaken this market discipline by making managers less fearful of acquisitions (Bebchuk et al., 2009). In addition, the erosion of value following GP adoption could be at least partly driven by a "selling-out" effect: executives might have some private information about the long-term independent value of their company, and GPs that are large enough might give them incentives to go along with an acquisition even when the their private information indicates that doing so would not be in the shareholders' long-term interest. However, our finding about the relationship between GPs and shareholder value provides no support for the view that, by weakening the pressures of the market for corporate control, GPs bring about increased firm value by inducing more focus on the long term (Stein, 1988) or by encouraging executives to invest in firm-specific human capital (Jensen, 1988; Shleifer and Vishny, 1989).

Because our stock return results include gains from acquisitions, our findings suggest that, notwithstanding their beneficial impact on acquisition premiums, the net overall effect of GPs is, on average, negative. Thus, our analysis reaches a less favorable conclusion concerning the use of GPs than does much of the literature, which has focused on the effect of GPs on acquisitions and not on their overall effect on shareholder value.

We would like to stress the "on average" aspect of our conclusion that GPs are, on average, associated with reduced value for shareholders. Our findings do not rule out the possibility that the use of certain types of GPs or of GPs in certain circumstances may have overall positive effects on shareholder wealth. Identifying which uses of GPs drive our "on average" results and which uses, if any, have overall positive effects on shareholder wealth is an interesting subject for future empirical work.

The remainder of this paper is organized as follows. Section 2 describes our data sources and provides summary statistics. Section 3 analyzes the relationship between GPs and expected acquisition premiums. Section 4 analyzes the relationship between GPs and evolution of firm value over time. Section 5 presents our conclusion.

[1] Earlier studies examining the relationship of GPs with acquisition likelihood include Harris (1990), Machlin et al. (1993), Cotter and Zenner (1994), Born and Trahan (1993), Hall and Anderson (1997), Agrawal and Knoeber (1998), Lefanowicz et al. (2000) and Bates et al. (2008). Most (but not all) of these studies find a positive association between GPs and acquisition likelihood. As to the relationship of GPs with premiums in the event of an acquisition, Machlin et al. (1993) report a positive correlation between the size of GPs and acquisition premiums. Fich et al. (forthcoming) find a negative association between GPs and premiums in the event of an acquisition. Sokolyk (2011) finds no statistically significant relationship between GPs and acquisition premiums. Hartzell et al. (2004) present related findings, which we discuss in Section 4 below.

[2] An analysis of the relationship of GPs and expected acquisition premiums was introduced in our working paper (Bebchuk et al., 2010). Fich et al. (forthcoming) adopt an approach similar to ours and obtain consistent results.

[3] Our results are thus consistent with and complement the significant body of literature showing how acquisition decisions are influenced by managers' private interests (see, e.g., Brickley et al., 1994; Cotter and Zenner, 1994; Cotter et al., 1997 Grinstein and Hribar, 2004; Jenter and Lewellen, 2011; Wulf, 2004).