

What happens to CEO compensation following turnover and succession?

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Abstract

When boards hire CEOs, the board and successor CEO have an opportunity to redesign the predecessor's compensation contract. The CEO's relative bargaining power will influence the outcome of compensation negotiations. Analyzing 508 successions, we find that total compensation of successor CEOs increases by 69% over their predecessor, but the structure of successor compensation is heavily influenced by the predecessors' contracts. When the board's bargaining power is large, successors have a greater proportion of pay-at-risk and smaller proportion of salary. When the CEO's bargaining power is large, there is a smaller proportion of pay-at-risk and relatively greater proportion of salary.

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1. Introduction

The principal/agent relationship between shareholders and management has garnered considerable attention among researchers, shareholder groups, and the financial press. When managers do not pursue shareholder wealth maximizing strategies, agency costs occur. One internal solution to the agency problem is the development of a compensation plan that aligns the interests of managers with those of shareholders. While the board can change the compensation structure

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of an existing CEO, a powerful CEO may successfully resist change (Bebchuk & Fried, 2004). However, when a board hires a successor CEO, the board has the opportunity to refocus the package without alienating an incumbent CEO.

The compensation literature is extensive. A large part of this literature focuses on the sensitivity of compensation to firm performance (e.g. Crawford, Ezzell, & Miles, 1995; Jensen & Murphy, 1990; Murphy, 1985, among many others) and how various firm characteristics impact compensation (e.g. Gaver & Gaver, 1993; Newman & Mozes, 1999; Smith & Watts, 1992).

There is another extensive body of literature that spans both the finance and management literature and has focused on CEO succession. Here, research has examined both the antecedents and consequences of CEO succession (e.g. Davidson, Nemec, & Worrell, 2002; Parrino, 1997; Shen & Cannella, 2003; Weisbach, 1988, among others).

In this paper, we examine successor CEO compensation packages and compare them to those of their predecessors.² At the time of succession, the board of directors has an opportunity to realign the CEO's incentives and perhaps to increase the relation between pay and performance. The board can correct mistakes made with the predecessor's contract and attempt to obtain optimal contracting. On the other hand, successor CEOs would likely want to bargain for a lucrative contract and may prefer a less risky form of compensation with less compensation related to performance. The outcome of this negotiation will likely depend on the bargaining power of the successor relative to that of the board.

Using a sample of 508 successions over a 12-year period, we find that successors earn more, on average, in total compensation than their predecessors. The non-performance-related portion of compensation decreases for the successors, but their pay that is sensitive to performance increases. The increase in pay related to performance occurs more often in firms with stronger boards (proxied by a factor that combines several measures of board strength). These boards likely have increased bargaining power and are more successful in redesigning the successor's contract to better relate pay to performance. However, we find some evidence that outside successors have greater bargaining power than insiders. Compared to inside successors their contracts have relatively greater fixed salary, less pay-at-risk, and are not as strongly aligned with the predecessors' contracts.

2. Theoretical development

In the sections below, we first discuss agency problems and compensation. We then relate these issues to turnover and succession and discuss how the turnover/succession event gives the board an opportunity to realign the CEO compensation contract.

2.1. Agency problems and compensation

When managers do not operate firms to maximize shareholder wealth, agency problems result and shareholders bear these costs. There are both external solutions to agency problems (e.g. takeovers, proxy fights, etc.) and internal solutions. One internal solution to the agency problem is the development of compensation plans linking management's compensation to the firm's performance. This internal solution, pay-for-performance compensation, may be more effective

² Murphy (2002) does compare inside successor compensation to that of outsiders, but it is not the primary focus of his study.

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