Researcher says CEO severance provisions impair stock performance

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New Orleans – When it was reported recently that Eugene Isenberg was stepping down as CEO of Nabors Industries Ltd. with a $100-million severance-style cash payout, the expressions of outrage the award provoked recalled the response to such notorious severances as the $210 million bestowed on Robert Nardelli by Home Depot or the $140 million paid to Michael Ovitz by Disney.

As in those two earlier deals, the Nabors payout seemed richly unearned in view of the fact that his company had underperformed the S&P 500 for the prior-year period, five-year period and 10-year period.

> The Freeman School's Peggy Huang says CEO severance agreements tend to lead to poor stock performance at S&P 500 firms.

But, outrageous as severance arrangements can be, the problem with them goes well beyond doubts about their fairness or propriety, new research finds. Not only do they bestow often-undeserved rewards for past results, but they impair a company's future performance as well, according to a paper that is the first to investigate how the structure of severance agreements affects shareholder wealth.

The study, by Peggy Huang of Tulane University's A. B. Freeman School of Business, reveals that firms with CEO severance agreements "show a significant underperformance in their future returns...underperform[ing] market benchmarks in the long run after controlling for size, risk, momentum, governance, and other factors."

And particularly harmful, she finds, are agreements, not too different from the one Isenberg had at Nabors, that provide for an all-cash payout. In the words of the study, "Firms that award cash-only severance contracts (without the equity component) to their CEOs perform significantly worse than those firms that also include the vesting of equity component in the agreements."

Indeed, all else being equal, Huang finds, a cash-only contract in force during a given year is associated with annual stock returns over the following three years that are 4.2 percent lower than the average returns of firms whose CEOs have no severance provisions in their contracts.

This contrasts with an average return lower by only 0.3 percent among companies whose CEO severance provisions specify payouts that combine cash with an accelerated vesting of equity. Such agreements typically allow the CEOs to sell immediately stock options and restricted stock that they might not otherwise have been able to touch for years.

Comments Huang: "Although less damaging to stock returns than cash-only agreements, deals with a large equity component, ironically, have the potential to arouse the greatest public outrage, because often it is equity that drives the dollar amounts of such deals sky-high. For example, people couldn't get over the fact that Nardelli was walking away from Home Depot with $210 million after a record that was middling at best; yet, less than 10 percent of that amount consisted of cash. And it is cash-only severance provisions in CEO contracts that most undermine firms' performance."

She adds: "Unfortunately, all-cash severance deals may be spreading faster than others. Since 2003, the percentage of S&P-500 CEOs who have severance agreements with equity elements has stayed level at about 36 percent, while the total number of severance agreements has risen from about 50 percent to over 55 percent. That latter figure, incidentally, compares with about 20 percent in 1993, meaning that the percentage of S&P CEOs with severance agreements has almost tripled over the past two decades. The findings of this study suggest that is not a healthy development."

Agreements lead to share-price volatility and increased risk

Huang's conclusions are based on an analysis of the relationship between severance agreements and companies' stock performance among the S&P 500 over the period 1993 through 2007. In an average year during that period about 40 percent of the 500 had contracts in force with CEO severance clauses, of which about 40 percent provided for all-cash payouts.

The professor finds severance agreements to be associated not only with stock underperformance but with high share-price volatility; with over-expenditure on research and development (which scholars view as riskier than other types of investments); with weak corporate governance, as measured by several standard indicators; and with increased incidence of CEO dismissals.

Wall Street has an inkling of these problems, Huang also finds, since stock prices, on average, fall by an unexpected 0.37 percent around the time when firms announce CEO severance agreements and rise an unexpected 1.41 percent when they eliminate them. Yet, statistically significant though these movements are, they "do not seem to anticipate the full extent to which those companies' stock underperform the market, on average, in the future," the professor writes.

For all the problems associated with them, severance deals have their defenders among scholars. As Huang explains, "Research suggests that CEOs are naturally disinclined to take managerial risks because so much of their wealth is tied up in a single company, in contrast to shareholders, who can spread their investment risk among many companies. One of the principal arguments in favor of severance agreements is that they provide a kind of insurance for CEOs that encourages them to take the risks required for company growth. Unfortunately, what this study reveals is that these agreements, particularly those providing for all-cash payouts, lead CEOs to take too much risk, as evidenced by stock volatility and overinvestment in research and development. In other words, management swings too far in the direction of risk.”

What, then, are companies to do? “If they can't avoid severance deals altogether, they should insist that equity be substantially represented, so that payouts depend substantially on how well the CEO performs. In addition, boards should probably not make severance deals without first assessing whether they have the capacity to provide the extra level of vigilance that these agreements require. Unfortunately, CEO severance is generally associated with weak boards rather than strong ones.”

Huang is an assistant professor of finance at the Freeman School. She presented an earlier version of the study, which is entitled “Marital Prenups? A Look at CEO Severance Agreements,” at the 2010 annual meeting of the Financial Management Association.