Can Huge CEO Golden Parachutes Hurt You?

How much do lavish CEO retirement packages cost shareholders?

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One of the unpleasant facts about investing in equity funds is the idea that you're paying for all sorts of things you probably shouldn't be—this obscure management fee, that needless trading cost. Can we add CEO extravagance to the pile?

In a world now casually described as the 1 percent versus everyone else, few things pique investor ire like the notion of C-level executives of publicly listed companies feasting on lavish compensation packages that don't appear to be matched by lavish performance. One popular measure of executive extravagance is the CEO-to-worker pay ratio. According to a striking report by the Economic Policy Institute this year, among the biggest 350 U.S. firms (as measured by revenue in any one year) it was 18.3 in 1965 and 209 in 2011, based on the value of executive option grants.

But there are the rewards CEOs get just for showing up every day, and the rewards they get for walking away. In the latter category, we observe that venerable institution known as the "golden parachute"—essentially severance packages that ensure no CEO leaves the game with anything less than Montana-sized boodle, no matter how he or she performs. The argument for this largesse is that you have to pay for management talent that would otherwise go elsewhere, and that loading up the executive booty wagon somehow aligns the interests of CEO and shareholder.

It's not an argument that the data unambiguously support, though. If anything, golden parachutes may create incentives that actually hurt shareholders in the long run.

Perhaps the best-known scholar of the subject is Lucian Bebchuk, who, along with Harvard colleague Alma Cohen and Stanford economist Charles Wang, wrote a 2010 paper that illustrates several perverse consequences of golden parachutes. Among them, firms that offer them are more likely to be acquired and to get a lower acquisition premium (relative to firms without golden parachutes). Golden parachutes tend to impair firm value, they found.

A 2011 study by Eliezer Fich and Ralph Walkling (both of Drexel) and Anh Tran (City University London) suggests that golden parachutes can create a "moral hazard" as regards takeovers. If such pay schemes are too meager, they can make executives overly resistant to mergers that might actually benefit shareholders of the targeted firm. If they're too generous, executives become overly eager to close deals in exchange for a personal windfall.

Examining 851 acquisition bids during the period 1999-2007, the authors found that parachute payments accounted for 30.5 percent, or $4.9 million, of the average merger payout received by target-firm CEOs. A 10-percent increase in the importance of the parachute relative to the merger pay package corresponds to a 5-percent drop in the premium paid for the target company, equal to a reduction of about $250 million for the average deal in the sample.

"Our findings indicate that when CEOs are given stronger incentives to sell their firms, vis-à-vis a larger parachute, they appear to do so even at the detriment of their shareholders," the authors wrote.

It's hard to put an aggregate number on the cost of golden parachutes to mutual-fund shareholders. What they cost you, in particular, depends on what funds you own and what stocks the funds own. But we can look at the cost to particular firms—some of which you've probably held in some fund or other—and they're not pretty. GovernanceMetrics International (GMI) published a report this year documenting 21 CEOs who since 2000 received "walk away" packages totaling more than $100 million each. The packages do not cover all of the CEO's earnings during his or her tenure, but do include items like the final year's salary and bonus, stock that vested during the final year, stock-option profits, cash severance payments, and deferred compensation.

Topping GMI's list are some familiar names: GE's Jack Welch (total walk-away payout: $417 million), Exxon Mobil's Lee Raymond ($320 million), and UnitedHealth's William McGuire ($286 million). The list runs on for another 18 CEOs and $2.9 billion.

Like a lot of things in the corporate world, these numbers are artifacts of a reasonable principle taken to an absurd extreme. Golden parachutes were meant partly to protect CEOs from financial harm they might incur in a merger. But "the principles were applied too widely," wrote GMI researchers Paul Hodgson and Greg Ruel. "They were applied not just to cash compensation, but equity compensation, perquisites, benefits, pensions, and virtually all other forms of pay. In principle, to protect someone from financial harm if they lose their job due to a merger, that executive needs a single year's salary and bonus."

Most of the CEOs in GMI's report received two or three years' salary and bonus, immediate vesting of equity and pensions, and retention of various benefits and perquisites. "A CEO who is retiring should not need a severance package as well as a retirement package," wrote Hodgson and Ruel.

CEOs defend themselves by arguing the value they add to their companies far outweighs size of their parachute. In some cases, that's debatable, but even where true it's beside the point. "We recognize that some of these CEOs added a huge amount of value to their companies, but then again, they already got paid for that," said GMI's Hodgson in an interview. "If you've been rewarded for your work at the company through incentives, either cash or stocks, surely that's enough reward without generating this incredibly generous retirement package on top."

Since shareholders seem relatively powerless to arrest the CEO pay racket, is government the only answer? During the depths of the financial crisis, President Obama promised to "take the air out of golden parachutes." Indeed, the Dodd-Frank financial-reform law mandates non-binding shareholder votes on adoption of merger-related golden parachutes by any listed company.

But legislative responses tend to generate their own perverse outcomes—partly, of course, because they're influenced by interested parties. GMI notes that in 1984, Congress imposed an excise tax on severance exceeding three times annual compensation. The result: Three times compensation became the floor, rather than the ceiling, for cash severance.

It's easy to say the only real answer is a more diligent shareholder class. But shareholders—especially individuals—are rationally apathetic and rationally uninformed about lots of things that impact their portfolios. The advantage always lies with the coteries of corporate elites (including compliant corporate boards) who decide, in essence, what they'll pay themselves—with reference, of course, to what other elites are getting.

"It might be a little strong to call it a racket, but it was certainly a very significant trend in CEO compensation," says GMI's Hodgson, referring to the sharp run-up in CEO pay over the past two decades. "Self-referencing is exactly what causes them all to come up to that point and say CEOs at X, Y, and Z companies are receiving this, therefore I should be getting it, too, because I have the same amount of experience."