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Promoting the Quiet Life or Risk-Taking? CEO Severance Contracts and Managerial Decision-Making

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Abstract


Using CEO severance contracts during 1992-2010, we find that CEOs with a severance contract tend to reduce corporate investments, impede innovation, and decrease firm risk across several dimensions, leading to shareholder value destruction. This negative value effect is stronger during the recent financial crisis period. Our findings suggest that severance contracts, rather than encouraging risky, value-increasing decisions, induce managerial shirking and destroy shareholder value. Such negative value impact is significantly mitigated for firms with stronger governance, greater growth, and in more competitive industries. We shed new light on the debate over regulation of executive compensation following the recent financial crisis.

Keywords: CEO severance agreement; Executive compensation, Shirking, Risk-taking, Innovation

JEL Classification: G31, G32, G34, J33

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