

The Impact of Golden Parachutes on Fortune 500 Stock Returns: A Reexamination of the Evidence

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Lambert and Larcker (1985) conclude that positive stock returns are associated with golden parachute adoptions from 1975 through 1982. Their evidence often has been used by corporate boards as a rationale for subsequent adoptions. Our study reexamines the effect of golden parachute adoptions on stock returns from 1982 through 1990. Our evidence indicates that stock returns associated with golden parachute adoptions by Fortune 500 firms changed from positive to negative during the 1980s. Thus, boards no longer can adopt golden parachutes based on the rationale that they are endorsed by stockholders.

INTRODUCTION

Golden parachutes provide executives with a form of compensation insurance in the event they are terminated following a change of corporate control. While golden parachutes alone have only a minor economic impact on potential takeovers, they represent (and often are accompanied by) a class of takeover defense mechanisms that potentially undermine the fundamental responsibility of executives and boards to represent the best interests of stockholders. During the merger wave that began in the early 1980s golden parachutes became increasingly controversial when terminated executives began to receive what often were regarded as unduly large payouts.

Because golden parachutes normally are provided to executives by boards without stockholder approval, their adoption sends a signal concerning the relationship between executives and boards. Corporate proxy statements often include stockholder proposals designed to prohibit golden parachutes. Boards usually respond by recommending that stockholders vote against such proposals because they severely restrict the firm's ability to attract high quality executives. The proxy voting process usually supports boards. True stockholder sentiment can be found, however, in stock returns associated with the announcement of golden parachute adoption.

Lambert and Larcker (1985) conclude that from 1975 through 1982 golden parachute adoptions were associated with positive returns to stockholders. Their evidence is consistent with a hypothesis that golden parachutes improve stock values by reducing conflicts of interest between executives and stockholders during a takeover. Subsequently, the Lambert and Larcker (1985) study often has been used by corporate boards as a rationale for golden parachute adoptions. Born, Faria, and Trahan (1993) provide evidence, however,

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that the positive returns observed by Lambert and Larcker (1985) may have been affected by investor perception of golden parachute adoptions as signals of pending takeovers. Thus, questions concerning investor sentiment toward golden parachutes remain unresolved.

Our study examines returns to stockholders in a sample of *Fortune 500* firms that adopted golden parachutes during the period 1982 through 1990. We explore the possibility that during this time period the motivation for adopting golden parachutes and the subsequent stock returns associated with adoptions changed. Our study period encompasses the rise in takeover activity during the early 1980s and the decline in takeover activity during the late 1980s. Our study period also includes the initiation of several legislative changes designed to regulate golden parachutes. Among these changes is the Deficit Reduction Act of 1984 which denies corporate tax deductions for excessive golden parachute payouts.¹

The increase in attempts to place restrictions on golden parachutes coincided with an escalation in golden parachute adoptions throughout the second half of the 1980s. Thus, the primary motivation for recent adoptions may be avoidance of future restrictions. If this notion is valid, recent golden parachute adoptions are more likely to signal information concerning executive influence with boards rather than information concerning executive incentives during takeovers. Our evidence is consistent with this notion. We find that stock returns associated with golden parachute adoptions changed from positive to negative during the 1980s.

COMPETING HYPOTHESES OF GOLDEN PARACHUTE ADOPTION

Prior studies have shown that target firm stockholders earn substantial profits when their firms are acquired (Jarrell, Brickley, and Netter, 1988). Changes in corporate control, however, can cause hardships for terminated executives through loss of wages while they seek new employment, possible reductions in pay levels when new employment is found, and loss of nonpecuniary benefits (Lambert and Larcker, 1985). Advocates of golden parachutes argue that pre-arranged severance agreements reduce conflicts of interest between executives and stockholders during takeovers (i.e., an alignment hypothesis). Thus, stock values will rise when golden parachutes are adopted because executives are more likely to support takeover offers that are beneficial to the firm's stockholders even though they may lead to termination of executives.

Opponents argue that golden parachutes reduce stock values by facilitating wealth transfers from stockholders to executives (i.e., a wealth transfer hypothesis). These wealth transfers can occur at least two ways. First, golden parachutes provide executives with some insulation from the market for corporate control and subsequently reduce the incentive for executives to run firms efficiently. Second, golden parachutes reduce the likelihood that stockholders will receive takeover premiums by increasing costs to bidders. In addition, because golden parachutes normally are provided by boards without stockholder approval, they also indicate the level of influence that executives have with boards and

¹ Excessive golden parachute payouts are defined as amounts greater than three times an executive's average total compensation over the five years prior to termination.

send signals regarding the potential for other forms of unexpected executive benefit consumption.

Lambert and Larcker (1985) study the 1975 to 1982 time period and find that positive stock returns are associated with golden parachute adoptions, a finding that is consistent with an alignment hypothesis. One interpretation of their evidence is that the cost of reducing conflicts of interests between executives and stockholders (i.e., golden parachute payouts) is low relative to potential stockholder gains from takeover premiums. Thus, any negative stock price effects caused by wealth transfers are more than offset by increased takeover efficiency.

Another interpretation of the Lambert and Larcker evidence suggests that from 1975 to 1982 relatively few firms adopted golden parachutes. Thus, investors were more likely to perceive golden parachute adoptions as signals of pending takeovers (i.e., a takeover signaling hypothesis). Positive stock returns would result from anticipation of future stock price premiums paid by bidders. A joint effect also would be possible where investors perceive the adoption as a signal of a pending takeover attempt and a means of reducing conflicts of interest between executives and stockholders during a takeover. Both anticipation of pending takeovers and reduction in conflicts of interest would be expected to cause positive returns. It is also possible that positive returns associated with anticipation of pending takeovers could offset negative returns associated with wealth transfers. In either case, it is likely that any takeover signal effect would dominate an effect from either reduction of conflicts of interest or wealth transfers.

Born, Faria, and Trahan (1993) provide evidence consistent with a takeover signaling hypothesis. They observe stock returns associated with golden parachute adoptions for two samples of firms. One sample from 1979 through 1989 contains firms that announced adoptions while in the process of being acquired. The authors argue that because the takeovers already had been announced, there should be no takeover signal effect. If an alignment hypothesis is valid, however, a reduction in conflicts of interest between executives and stockholders still should cause positive stock returns. Tests on this sample establish that no significant stock returns are associated with golden parachute adoptions.

Their other sample, from 1979 through 1984, contains firms that were not in the process of being acquired when they announced golden parachute adoptions. Tests on this sample indicate that golden parachute adoptions are associated with positive stock returns. The authors argue that the combined evidence is consistent with a takeover signaling hypothesis but not consistent with an alignment hypothesis.

Because golden parachutes are unlikely to be a significant hindrance to takeover attempts,² the real issue associated with golden parachute adoptions is the information signaled. There are at least two components to this information. One component provides insight concerning the level of executive influence with boards and the likelihood that increased influence will lead to additional unexpected executive benefit consumption.

² Born, Faria, and Trahan (1993) study 36 firms that adopted golden parachutes while they were acquisition targets. None of the 36 takeovers were abandoned as a result of golden parachute adoptions. There also was no evidence that golden parachute adoptions had adverse effects on negotiations or caused reductions in takeover offers.

Another component concerns insight into the likelihood of a future takeover through disclosure of inside information. While the net effect of these two components can vary across the population of firms, there is reason to believe that stockholder perception of the combined information signaled has changed in recent years.

The wave of takeovers that began in the early 1980s provided corporate boards with an incentive to adopt takeover defenses that often included golden parachutes. In turn, regulatory agencies began to consider restrictions on golden parachutes and other corporate control mechanisms. Beginning with the Deficit Reduction Act of 1984, these agencies have moved toward controlling both the size of golden parachute payments and the ease of adoption (Longnecker, Cross, and Wood, 1992). Congress also has considered bills that seek to mandate stockholder approval of golden parachutes and several other executive benefits (Nathans, 1987).

At the same time that regulatory agencies were seeking to increase golden parachute restrictions, corporate boards were escalating golden parachute adoptions. Adair (1987) finds that prior to 1987, 30 percent of the top 250 industrial firms provided their executives with golden parachutes. Toyne and Millar (1994) study *Fortune 500* firms from 1986 through 1989 and find that 36 percent of the firms in their sample had golden parachutes in 1986. By 1989 65 percent of the same firms had golden parachutes. In the sample selection procedures used in this study we observe a sample of firms in the 1991 *Fortune 500* and find that 72 percent had provided golden parachutes to their executives.

The escalation in golden parachute adoptions over the past few years provides an opportunity to check for consistency in the findings of the Lambert and Larcker (1985) study over time. If an alignment hypothesis describes stock returns associated with golden parachute adoption, then we expect that even though golden parachute adoptions are likely to be motivated by pending restrictions, they still should reduce conflicts of interest between executives and stockholders during a takeover. Thus, golden parachute adoption should cause positive returns. If golden parachutes currently are adopted in order to avoid future regulatory restrictions, however, then investors may perceive golden parachutes as a form of wealth transfer. In this case we would expect negative stock returns at the announcement of golden parachute adoptions.

Negative returns also would be expected if the positive returns in the prior study were affected significantly by investor anticipation of a pending takeover. Despite the decline in takeover activity in the second half of the 1980s, golden parachute adoption could signal a pending takeover for some firms in a sample. Any positive stock returns would be diluted, however, by negative returns as the proportion of sampled firms adopting golden parachutes to avoid restrictions increases.

In summary, evidence of positive returns at the announcement of golden parachute adoptions in a sample of firms from a more current study period would be consistent with an alignment hypothesis and the Lambert and Larcker (1985) study. Evidence of negative returns would be consistent with a wealth transfer hypothesis and indicate that either investor sentiment for golden parachutes has changed since the Lambert and Larcker (1985) study or the results of their study were affected significantly by investor expectation of pending takeover attempts.

SAMPLE SELECTION AND EVENT STUDY METHOD

We initially select a random sample of 100 publicly traded members of the 1991 *Fortune 500*. The presence of golden parachutes in executive compensation contracts is identified by examining annual proxy statements for the year 1991. Seventy-two of the firms in our original sample provide their executives with golden parachutes. We then search prior proxies to determine the year that golden parachutes first were included. Like Lambert and Larcker (1985), the SEC date stamp on the annual proxy statement from the adoption year is used as the announcement date.³

Firms are omitted from the sample if the SEC date is not available. All firms must have stock return data available on the Center for Research in Stock Prices (CRSP) tapes. To avoid confounding our results we examined the *Wall Street Journal Index* and excluded firms that announced pertinent information such as earnings, dividend adjustments, or restructuring activity during a 21 day period around the announcement date (i.e., ten days before and ten days after). Forty-one firms survived the sample selection procedure. Adoption dates range from 1982 through 1990.

We use a form of the standard event study method described in Dodd and Warner (1983) with the Karafaith and Spencer (1991) adjustment to measure the impact of the announcement of golden parachute adoption on a firm's stock returns. Each firm's abnormal returns at the announcement are obtained using regression analysis to predict an expected return for each day in a selected interval and then subtracting the expected return from the actual return over the same interval. Thus, we first estimate the following model:

$$(1) R_{j,t} = \alpha_j + \beta_j R_{mkt} + \varepsilon_{j,t}$$

where:

- $R_{j,t}$ = The actual rate of return on security j for day t ;
- R_{mkt} = The return on the CRSP value-weighted index on day t ;
- α_j and β_j = Estimated parameters; and
- $\varepsilon_{j,t}$ = An error term for security j on day t .

The day that the proxy containing the golden parachute announcement is received by the SEC is considered the event date (day 0). All other days are measured relative to this date. Thus, days -1 and 1 are the trading days immediately prior and after the announcement date, respectively. The regression parameters for equation (1) are estimated over the interval (-65 to -6) and are assumed to remain constant over the interval (-5 to 5). Thus, the market returns can be used to predict the normal return to the firm.

³ This procedure is appropriate because golden parachutes normally are awarded by boards without stockholder approval. Thus, the first notification that stockholders officially receive from the board is in their annual proxy statement. It is possible that disclosure of golden parachute adoptions could have occurred at an earlier date, however, especially in cases where golden parachutes were used as part of a takeover defense. In this case, the impact of takeover anticipation on the study's results would be softened because the effect of a takeover signal could be over by the time proxies are distributed.

For security j , the abnormal return (AR) for day t is computed as the difference between the actual return and the predicted normal return from the market model as described by the following equation:

$$(2) \text{AR}_{j,t} = R_{j,t} - (\alpha + \beta_j R_{\text{mkt}})$$

Abnormal returns are accumulated across firms and across an 11 day event window (-5 to 5) around the proxy receipt date. The cumulative abnormal return (CAR) for the 11 day interval is used to test the two competing hypotheses using a significance level of at least $\alpha = 0.05$.

RESULTS

Table 1 contains the event study results for the full sample of observations. Seven of the 11 daily abnormal returns are negative, and the cumulative abnormal return remains negative throughout the event period. Over the entire 11 day period the cumulative abnormal return is negative but not statistically significant. Thus, the results of our tests on the full sample are not consistent with any of the competing hypotheses and conflict with the positive and statistically significant abnormal returns in the Lambert and Larcker (1985) study.

Table 1—Results of the Event Study of Stockholder Returns at the Announcement of Golden Parachute Adoptions for the Full Sample Firms

DAY	AR	DAILY T	CAR	CUM Z
-5	-0.00242	-1.21354	-0.00242	-1.21354
-4	-0.00277	-0.84667	-0.00519	-1.45820
-3	-0.00133	-0.60709	-0.00652	-1.54112
-2	-0.00362	-0.61515	-0.01014	-1.64223
-1	0.00065	0.17323	-0.00949	-1.39138
0	0.00527	1.50767	-0.00422	-0.65465
+1	-0.00067	-1.03971	-0.00835	-1.52170
+2	-0.00346	-1.66076	-0.00835	-1.52170
+3	0.00478	0.87480	-0.00357	-1.14370
+4	0.00027	0.10167	-0.00329	-1.11657
+5	-0.00169	-0.75802	-0.00498	-1.29316

AR = The daily abnormal return;
 DAILY T = The significance of the daily abnormal return;
 CAR = The cumulative abnormal return ;
 CUM Z = The significance of the cumulative abnormal return

It is possible that the combination of legislative changes that began during the first half of the 1980s and the decline in takeover activity during the second half of the 1980s caused a change in the motivation for adopting golden parachutes (and, therefore, the information signaled). Thus, it is also possible that our sample has captured a change in investor sentiment over time or that negative investor sentiment during the first half of the 1980s was offset by investor perception of golden parachute adoptions as takeover signals. In either case, abnormal returns associated with golden parachute adoption during the early years in our sample could be different than abnormal returns during the later

years. If the abnormal returns are different, the net effect would be to dilute the collective returns to our sample.

In order to test for a change in the abnormal stock returns we divide our observations into two subsamples and perform an event study on each subsample. The first subsample contains 18 observations from 1982 through 1985. The second subsample contains 23 observations from 1986 through 1990. We are not sure when a change in adoption motivation may have occurred. We assume that, because the Deficit Reduction Act of 1984 was the first major legislation that provided some control of golden parachutes, any motivational change should have occurred around that time. If a change in abnormal stock returns began around 1984, then inclusion of 1985 in the first subsample should bias test results against finding a difference in subsample cumulative abnormal returns by including postchange observations in a prechange sample. Thus, we reduce the likelihood of finding a difference and increase the conservativeness of our conclusions by splitting the sample at 1986.

In summary, if investor sentiment toward golden parachute adoption changed during the 1980s or if negative investor sentiment during the first half of the 1980s was offset by investor perception of golden parachute adoptions as takeover signals, then we expect to find that the cumulative abnormal return associated with golden parachute adoptions are different across time periods. More specifically, we expect that the cumulative abnormal return will be positive for the subsample from the earlier time period and negative for the subsample from the later time period. We also expect that the negative cumulative abnormal return for the subsample from the later time period will be significantly less than the cumulative abnormal return for the subsample from the earlier time period.

Twelve of the 18 observations in the sample from the earlier time period resulted in positive cumulative abnormal returns and six resulted in negative cumulative abnormal returns over the 11 day event window. Only four of the 23 observations in the sample from the later time period resulted in positive cumulative abnormal returns, while 19 resulted in negative cumulative abnormal returns. There were five observations in 1985, three with positive cumulative abnormal returns and two with negative cumulative abnormal returns.

Panel A of Table 2 presents the event study results from the subsample of firms from the 1982 to 1985 time period. Only one of the 11 daily abnormal returns (day -2) is negative. The cumulative abnormal return is a positive 2.3 percent but not statistically significant at the $\alpha = 0.05$ level. Therefore, the results of tests on the subsample of firms from the earlier time period are not consistent with any of the competing hypotheses.

Panel B of Table 2 presents the event study results from the subsample of firms from the 1986 to 1990 time period. These results are consistent with a wealth transfer hypothesis. Seven of the 11 daily abnormal returns are negative. The cumulative abnormal return over the 11 day event window is negative (-2.7 percent) and statistically significant ($\alpha = 0.01$). This abnormal return is 5.0 percent less than the cumulative abnormal return to the sample from the earlier time period described in Panel A (i.e., (+2.3 percent) - (-2.7 percent)) and the difference is statistically significant ($\alpha = 0.01$)⁴ Thus, stock returns associ-

⁴ We also test for a change using regression analysis. The dependent variable in the model is each observation's cumulative abnormal return. The independent variable is a binary variable, 0 for observations from 1982 to 1985 and 1 for observations from 1986 to 1990. The relation between the cumulative abnormal

Table 2—Comparison of Event Study Results for Subperiods 1982 Through 1985 and 1986 Through 1990**Panel A: 1982 through 1985**

DAY	AR	DAILY T	CAR	CUMZ
-5	0.00081	0.33466	0.00081	0.33466
-4	0.00287	1.20632	0.00368	0.61635
-3	0.00240	0.58656	0.00608	0.84190
-2	-0.00933	-2.13423	-0.00325	-0.33801
-1	0.00172	0.07250	-0.00153	-0.33475
0	0.00127	0.08398	-0.00026	-0.27130
+1	0.00600	1.16543	0.00574	0.18932
+2	0.00629	0.82546	0.01203	0.46893
+3	0.00642	1.73825	0.01845	1.02153
+4	0.00061	0.28524	0.01906	0.87891
+5	0.00418	1.09287	0.02324	1.16752

Panel B: 1986 through 1990

DAY	AR	DAILY T	CAR	CUMZ
-5	-0.00495	-1.32419	-0.00495	-1.32419
-4	-0.00719	-2.20027	-0.01214	-2.49217
-3	-0.00424	-1.32946	-0.01638	-2.80241
-2	0.00085	1.06674	-0.01553	-1.89359
-1	-0.00018	-0.29542	-0.01572	-1.56156
0	0.00839	1.93867	-0.00732	-0.63404
+1	-0.00589	-2.41917	-0.01321	-1.50137
+2	-0.01110	-2.94759	-0.02431	-2.44653
+3	0.00351	0.36976	-0.02080	-2.42987
+4	0.00001	0.11659	-0.02079	-2.26830*
+5	-0.00628	-1.97888	-0.02707	-2.75940*

* Statistically significant at the $\alpha = 0.01$ level

ated with golden parachute adoptions changed during the 1980s from positive to negative. The change coincided with a decline in takeover activity and the initiation of legislative restrictions on golden parachutes which may have encouraged boards to adopt golden parachutes to avoid future restrictions. Consequently, investor perception of the information signaled by more current adoptions results in negative stock returns.

SUMMARY AND CONCLUSIONS

This study provides evidence that stock returns associated with golden parachute adoptions have changed from positive to negative since the time period studied by Lambert and Larcker (1985). The negative cumulative abnormal return to stockholders in a subsample of firms from the 1986 to 1990 time period is consistent with a wealth transfer hypothesis.

The results of this study should discourage future golden parachute adoptions that are based on the rationale that golden parachutes are endorsed by stockholders. Stockholders currently perceive golden parachute adoption as an unfavorable signal concerning executive influence with the board and board attitudes towards stockholder interests. This perception manifests itself in adverse stock price performance.

return during the announcement period and the binary variable is negative and statistically significant ($\alpha = 0.01$) which is consistent with a change across time periods.

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