

# Nothing Lasts Forever

## A Different Way To Structure Severance

When a CEO receives  
a massive payout in  
the face of job cuts and  
a precipitous drop in  
stock price, should we  
really be surprised to  
see shareholders (and  
the public) get upset?

Maybe. After all, at the time of hire many shareholders were happy to provide their new CEO “protection” against a change in control or firing if that’s what it took to get the sought-after leader on board. The turnaround, therefore, is a bit hypocritical — it’s a little like wanting to revoke a prenuptial agreement years later when a marriage goes bad. In this column I highlight a few issues related to severance and change in control in CEO pay contracts, and consider an alternative way to pay.



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### Severance and Other Up-Front Payments

I suspect it is the case that no one really wants to pay for failure. The problem is that if failure could be reasonably anticipated at the time of hire, then the board wouldn't have made the offer in the first place.

It's perfectly reasonable to offer a large severance or change-in-control agreement at the time of hire. The CEO candidate likely already has a good job that she enjoys with (perhaps) some security, money on the table (in terms of unvested stock and stock options) and likely a community of friends and colleagues, many of whom would be left behind. It is perfectly natural (“rational” in the jargon of economists) for the new CEO to negotiate to be kept “whole” (at least financially) in the case of a change in control or firing. An example is William Anders, CEO of General Dynamics (as noted by Kevin J. Murphy and Jay Dial in “Incentives,

downsizing, and value creation at General Dynamics” in *Journal of Financial Economics*), who said, “I negotiated a great contract because I wanted total independence. I realized the risk involved in working for a large shareholder [the Crown family] and I wanted to be independent from that risk. First, I wanted GD to make me whole from what I was giving up at Textron. Then, I wanted an agreement so that I would be able to retire on the day I walked in here.” To be honest, isn’t this the kind of independently minded, self-confident go-getter that many would argue is exactly what the shareholders are seeking in a new CEO?

### Why Does the CEO Get So Much When the Company Tanks?

But, when independent, confident go-getting goes bad, many are outraged if the company tanks and the fired CEO walks off with millions. “I would’ve driven the company into the ground for half that” is the offer I’ve heard from many a generous soul. Of course, the people making this generous offer are not being recruited to run major companies, and more to the point, the severance and change-in-control agreements are negotiated up front when the balance of power at the time of hire may be tipped in favor of the recruited CEO. Firms rarely make the choice between candidate A at price X and candidate B at price Y. Instead, the best candidate is picked and then compensation is negotiated to win over the desired one. Lucian Bebchuk and Jesse Fried in *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004) provide a detailed and critical account of the CEO pay-setting process.

### Tapering Change-in-Control and Severance Protection

As noted, many severance and change-in-control agreements are set to make the executive whole so that he or she can (in part) make up for any unvested stock or options that are left behind at the old company. One way to deal with this is to simply offer a lot of stock and options to the new CEO at the time of hiring, and this is often done. But many argue that severance and change-in-control payments are also needed since, at the time of hiring, the executive only has so much wealth in the new company, and it will take time for the executive to build that up (through stock and option grants over time). So one of the reasons executives

have severance and change in control in their contracts is to make sure they have enough if something goes wrong earlier on.

It seems to me that one reasonable modification would be to taper severance over time as the CEO’s wealth in the firm builds. Consider the following example. In one contract option, at the time of hiring, the executive is promised \$20 million in the event of a firing, no matter when the change in control happens. In the second contract option, the executive is offered \$25 million in the event of firing if the firing happens in the first two years on the job, and offered \$15 million in the event of firing if the firing happens in the third or fourth year, and offered \$5 million in the event of firing if the firing happens in the fifth or sixth year, and nothing if a firing happens after that. In fact, I would design this with less sharp kinks in the plan (e.g., a smoother taper), but this illustration still makes the point.

This plan allows the executive time to accumulate wealth

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to make him or her whole. But it also offers him or her more in the first two years but less later. So, in expectation (depending on the probabilities of firing at given times), this could be of equivalent cost for the company. The reasonableness of tapering severance suggests to me that some companies have already adopted it. The optimal degree of tapering, the impact of tapered severance on performance and other issues, however, remain rich topics for research. [WS](#)



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