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Contracts protecting the CEO

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Give your CEO long-term contractual security to avoid short-term thinking

When former General Electric CEO, Jack Welch, retired with a US$417 million severance package in 2001, it sparked such outrage that the U.S. Securities and Exchange Commission eventually made it a requirement for publicly-listed companies to quantify pay agreements with top executives. Although "Neutron Jack" did transform GE into a US$410 billion dollar company – the most valuable company in the world at the time – it left shareholders and the public at large wondering, "Did GE really have to pay THAT much?!"

"It can be tricky if the amount of severance pay is outrageous," says **Qiang Cheng**, Associate Dean for Research, and Professor of Accounting at the Singapore Management University. "If the severance pay is about two times the annual salary, usually shareholders will not complain about it too much."

CEO contractual protection and myopic behaviour

Despite media and shareholder scrutiny on the CEO's contract, the main job of the Chief Executive remains the same: to ensure the company's long-term viability. In his research paper, "*CEO contractual protection and managerial short-termism*", Cheng makes for the case that giving a CEO the security of a severance pay agreement frees him up to build the long-term future of the company. Specifically, such CEOs are less likely to cut R&D expenditures to avoid earnings decreases which reflect badly on the CEO in the short-term.

Using data that covered S&P 500 firms from 1995-2008, Cheng and his coauthors analysed the likelihood of a CEO without contractual protection to cut R&D spending vis-à-vis one who did. They wrote thus in the paper:

"…we compare(d) the pre-tax, pre-R&D earnings of the current year with the prior year. If there is a decrease but the decrease is smaller than the prior year's R&D, the firm can potentially avoid an earnings decrease by cutting R&D in the current year."

There were 465 such occurrences in Cheng's research sample, of which 163 instances or firm-years featured a CEO without contractual protection. Within that group, 105 instances (64 percent) saw a R&D spending cut.

On the other hand, of the 302 occurrences which featured a CEO with contractual protection, only 141 (47 percent) of them saw a decrease in R&D spending, which suggests that the contractual protection has done what it was supposed to do, i.e., free the CEO from having to deliver short-term performance just to keep his job.

"The point of the CEO contractual protection is to encourage the CEO to take the risk and invest in positive NPV projects which may or may not succeed," Cheng told *Perspectives@SMU*. "The CEO's contractual protection helps in that it gives the CEO a fixed term, be it three years or five years. If he or she does not perform well within that period, the board cannot easily fire the CEO. However, the board still has the choice to fire the CEO after paying the severance pay; so they still have the flexibility. "

Transient investors and the Board

Even so, CEOs of publicly listed companies have to deal with institutional investors who buy shares for the expressed desire to turn a quick profit. For CEOs of such companies, contractual protection would have a bigger impact on how myopic his or her thinking becomes.

"There are shareholders that are transient institutional investors who want to make quick money," Cheng says. "From their perspective, they just want the share price to be high in the short term so they can sell the shares for a profit. Those kinds of shareholders encourage the CEO to be myopic, and the CEO has to be myopic in that situation because if he isn't, these shareholders will make noise and try to get rid of the CEO. If the CEO has the contractual protection, then he can say, 'OK, I can think long term.'"

Cheng explains that the Board of Directors has to decide whose interests it should be serving – the long-term shareholders' or the transient ones? It highlights another main point the paper makes: the moderating effect of CEO contractual protection on the extent of myopic behaviour is weaker in firms with higher board independence than in other firms. In other words, there is less need for CEO contractual protection when the board is more independent.

"Board independence basically is trying to capture how many outsiders serve on the board, or how independent the directors are from the current CEO," Cheng explains. "On the board you have the executives, which usually include the CEO, and occasionally the CFO or President. Those are the insiders, the executive directors. You also have independent directors such as retired CPAs, partners or professors, or experts in the finance industry etc."

Cheng continues, "If the board is independent, it can monitor the CEO to make sure he's working in the best interest of the long-term shareholders. If CEO contractual protection is also to encourage CEOs to think long-term or reduce myopic behaviour, when you have an effective board that's trying to achieve the same objective, the impact of CEO contractual protection is lower."