Discussion of

Golden Parachutes and the Wealth of Shareholders

Authors

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Authors provide a comprehensive empirical analysis of

- Relation between golden parachutes (GP) and firm value:
  Negative correlation.

- Relation between GP and probability of being acquired:
  Positive correlation.

- Relation between GP and acquisition premium:
  Negative correlation.

The paper is

– Well-motivated (provides the economic and policy underpinnings of the debate surrounding GP).

– Sample is carefully chosen; allows for the first comprehensive analysis of GP.

– Empirical analysis is thoughtful and thorough.

– Well-written.

Paper will have a significant impact on corporate and regulatory policy regarding GPs.

Corporate Governance and Endogeneity

Performance = f_1(Governance, Ownership, Capital Structure, Z_1, e_1),

Governance = f_2(Performance, Ownership, Capital Structure, Z_2, e_2),

Ownership = f_3(Governance, Performance, Capital Structure, Z_3, e_3),

Capital Structure = f_4(Governance, Performance, Ownership, Z_4, e_4).

Z_i : vectors of control variables

e_i : error terms associated with exogenous noise and the unobservable features of managerial behavior or ability that explain cross-sectional variation in performance, ownership, capital structure and governance.

The Econometric Problem

Performance, governance, ownership and ***capital structure*** are interrelated.

A firm's corporate governance measure might be affected by the same unobservable features of managerial behavior and managerial ability that are linked to ownership and performance.

If these variables are endogenously determined, standard estimation techniques (OLS, probit) yield biased and inconsistent results.

Table III

Powerful univariate time-series evidence (1990 – 2006)

- Firms with GP more likely to receive a bid: 17 of 17 years.
- Firms with GP more likely to be acquired: 15 of 17 years.

Table IV

Probit models for acquisition likelihood

- Probability of receiving a bid.
- Probability of getting acquired.

Caveat: Endogeneity problem noted earlier.

Other determinants of acquisition likelihood could be included:

- Past firm performance,
- Ownership structure (CEO ownership, block ownership of directors, block ownership of institutions) –

see, for example, Bhagat and Jefferis (2002, "The Econometrics of Corporate Governance Studies," MIT Press)

Table IV

Probit models for acquisition likelihood

- Probability of receiving a bid.
- Probability of getting acquired.

Probit estimates are biased and inconsistent if the latent error terms are heteroscedastic.

Suggestion: Manski's (1975, JE) score estimator provides consistent estimates.

Table VIII

Firm value (measured via Tobin's Q) is negatively correlated with future GP adoption.

Suggestion for another governance measure as a control variable:

Dollar ownership of the median director;

see Bhagat and Bolton (2008, JCF).

Table IX

GPs and Stock Returns over time

Consider the following “trading strategy.”

“We long a portfolio of stocks that adopt golden parachute two volumes from the current one… (or adopts GP 4 to 8 years from now)” – page 24

A trading strategy cannot be based on knowledge of future events/information.

Table IX

GPs and Stock Returns over time

"Trading strategy" generates compounded annualized abnormal returns of

-6.85%

- Is this return realizable on the basis of real-time data availability (see previous slide)?
- Efficient market implications? (Have these returns changed over time within their sample period?)
- Out-of-sample test: Do these results hold during 2006-2009?
- What proportion of the above returns attributable from the short portfolio? (Larger transaction costs.)

Summary

The paper is well-motivated, thoughtful, thorough, and well-written.

Paper will have a significant impact on corporate and regulatory policy regarding GPs.

I quite enjoyed reading the paper and strongly recommend it to corporate governance and corporate law scholars.