WHAT CAN THE DEPARTING CHIEF EXECUTIVE COMPENSATION STRUCTURE TELL US?

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Abstract

This paper examines the amount and structure of the pay package for the departing CEO in a company around CEO succession. I find that the characteristics of the departing CEO compensation can provide valuable information regarding the incoming changes in corporate governance around the succession. Specifically, when a departing CEO is entrenched with a "better" compensation package characterized with a greater amount of pay in cash and in total at a lower risk, the CEO, after his retirement, is more likely to remain on the board as a director or become the chairman of the board, persuade the board to pick an insider rather than an outsider to be his successor, and to promote the company's current president and/or chief operating officer to be the incoming CEO. These findings are consistent with the management entrenchment theory that when a CEO is entrenched with a greater discretionary power and better personal benefits, he is more likely to use his managerial power to continue his influence on the company even after he retires from the CEO position.

Keywords: CEO Succession, Departing CEO Compensation, Routine Succession

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Introduction

The incentive contract for top executives has been a topic of great interest for academics, practitioners, and policy makers for a long time, especially since the 2008 global financial crisis. For example, in response to the 2008 financial crisis, U.S. passed the Wall Street Reform and Consumer Protection Act on July 27, 2010 in order to to strengthen shareholder rights by providing shareholders the right of a non-binding vote on executive compensation. The effects of Say on Pay (SoP) law on CEO compensation draw the attention from the academics (e.g., Correa and Lei, 2013). There is also a debate recently over how to implement the Dodd-Frank Act that require companies for the calculation and disclosure the ratio of CEO compensation to the median employee pay in a company in the U.S. (Bikard, 2011).

The majority of academic literature the CEO compensation area focus on the relation of firm performance and CEO compensation, the amount and structure of new CEO pay packages, as well as how CEO successions provide a good opportunity for a company to optimize its CEO incentive contracts at the interest of shareholders (e.g. Cao and Wang, 2013; Mobbs and Raheja, 2012; Elsaid et al. 2009). This study examines the amount and structure of CEO compensation from a unique perspective – the amount and structure of compensation for the departing CEOs.

I explore the information content of the departing CEO pay packages for the incoming changes in corporate governance around CEO succession announcements, and find that the characteristics of departing CEO compensation indeed provide valuable information regarding the incoming changes. Specifically, I find that if a departing CEO is "entrenched" with a better compensation package, such as a greater amount of cash and total compensation at a lower level of risk, the CEO is more likely to retain as a board member or the chairman of the board. The departing CEO is also more likely to support the promotion of the company's current chief operating officer or president to be the next CEO, and does not want to accept an outsider to be his successor. An outsider is generally expected to bring substantial changes to the company, therefore, threaten the established power of the departing CEO in the company. The findings in this study are consistent with the management entrenchment hypothesis that when a CEO is entrenched with a greater power and better personal benefits, he intends to continue his influence in the company after retirement from the top position.

In addition, I compare the pay for the departing CEOs and that for the incoming CEOs, and find that the level and the risk of the departing CEO compensation are significantly lower than that for the incoming CEOs. This indicates that boards intend to offer a larger a pay package to attract high talent new CEOs, at the same time use the chance to optimize its CEO incentive contracts by increasing restricted stocks, stock options, and other long-term incentive compensation. The equity-based compensation based

on a company's stock performance has been widely considered to be a more effective incentive to align managerial interests with shareholder wealth. The evidence also shows that the redesign of the new CEO compensation package is beneficial to the company and its shareholders given that the companies in the sample are growing measured in total assets, market capitalization, and sales. The sample of firms also has an improved financial position (i.e., higher earnings, ROE and stock returns) in average in the year following the CEO succession announcements. The departing CEOs are also found to have a greater amount of compensation in large-size firms, in growth firms with more investment opportunities, and in the companies that operate in unregulated industries, though their pay packages incur a higher risk.

The paper is organized as follows. In Section II, I review the literature and develop the hypotheses. Data and sample selections are described in Section III. I perform the empirical analysis from Section IV to VI. The conclusions and the discussions are presented in Section VII.

Literature Review and Hypothesis Development

Bebchuk et al. (2005) construct a management entrenchment index using six corporate governance provisions, and find a negative relation between the entrenchment index and firm value. They argue that it is the managerial power rather than the pursuit of optimal contracting can explain the executive compensation practices in the United States (Bebchuk et al., 2002; Bebchuk et al., 2004). Under their management entrenchment hypothesis, executives can influence their compensation using their discretionary power obtained from their positions, shareholdings, as well as their control of the board. The theory views executive compensation as part of the agency problem that the entrenched managers use their influence over compensation design to obtain personal benefits. They further find that the stock option granting practices in many U.S. publicly-trade companies cannot be fully explained by the optimal contracting theory. Rather, such practices indicate that the effects of a managerial power approach towards compensation.

When an entrenched CEO steps down from the top position, he is very likely to use his power to influence the board on the new CEO selection process so he can continue his entrenchment on the company for the purpose of personal reputation and financial benefits. Many factors, such as CEO tenure, CEO stock holdings, CEO duality, and so on, can be used to measure CEO power or entrenchment. The compensation variables, including the amount of compensation in cash and in total and the proportion of equity-based compensation, can also be used to measure the power of a CEO. The reasoning is that if a CEO is entrenched with a greater discretionary power, he is more likely to negotiate a more favorable compensation package characterized a larger amount of compensation at a lower risk. This has been documented in prior studies. For example, Finkelstein and Boyd (1998) and Wang et al. (2009) have documented a significant positive relation between managerial discretion and CEO compensation. Toyne, Millar, and Dixon (2000) find that the entrenched CEOs bias their compensation structure towards a lower level of risk so their pay packages cannot be affected by firm performance significantly. Elsaid and Davidson (2009) argue that CEOs may prefer to be paid in ales risky manner, which means that they would like to be paid well regardless of firm performance.

A departing CEO whose power can be measured by compensation variables in this study can use various ways to continue his influence on the companies after his retirement. For example, the departing CEO can stay on the board as a director or become the chairman of the board, persuade the board to pick his successor from inside rather than outside the company, and promote his long-time designated successor, the president or chief operating officer of the company. In this section, I will develop three hypotheses regarding what the departing CEO compensation can signal to the market regarding the incoming corporate governance changes around the company's CEO succession process.

In a normal or a "routine" succession, a departing CEO steps down from the top spot but still stays on the board as a director, or become the chairman of the board. The position in the board, especially the chairmanship, can make the retiring CEO continue his significant influence on the company's strategic decisions, corporate governance changes, and executive compensation policies. Therefore, if a CEO is "entrenched" with a greater discretionary power, which is positively related to the amount of compensation (Finkelstein and Boyd, 1998; Wang et al., 2009) at a lower risk, he is more likely to negotiate a board seat or the chairmanship after his retirement from the CEO position. Therefore, I develop the first testable hypothesis as follows.

> *H1: When a departing CEO is entrenched with a better pay package characterized with a larger cash and total compensation at a lower risk, he is more likely to remains on the board as a director or become the chairman of the board after his retirement.*

Based on the relay-succession theory, a company can give the heir apparent executive the title of Chief Operating Officer (COO) and/or president, and this usually happens under the leadership of the former CEO. When the former CEO departs for other position, he is very likely to persuade the board to appoint the designated heir into the new CEO position after a period of training. The process is more likely to happen when the departing CEO has a greater

discretionary power which is highly related to a better compensation package with a larger cash and total compensation at a lower risk (Finkelstein and Boyd, 1998; Wang et al., 2009). Therefore, the departing CEO tends to favor a relay succession by promoting his designated Chief Operating Officer (COO) and/or the president to be the new CEO. In this way, the entrenched CEO can continue his influence on the company. So the second hypothesis is developed as follows.

> *H2: When a departing CEO is entrenched with a better pay package characterized with a larger cash and total compensation at a lower risk, he is more likely to favor a relay CEO succession process by promoting the company's president and/or chief operating officer to be the new CEO.*

The CEO successor origin has been extensively documented in prior literature. As a signal for significant change to the market, a firm is more likely to hire an outsider rather than an insider to be its new CEO in response to poor performance (Cannella and Lubatkin, 1993; Davidson et al. 2002). Vancil (1987) argues that if a company hires an outsider as its new CEO, it is a signal that major change in the company is necessary and that no insiders can bring fresh perspective that is needed for the company's current situation. However, Shen and Cannella (2002) find that outside CEO successions can create hostile attitudes and resistance from insiders, who were mostly the subordinates of the former CEO. If a departing CEO with a greater bargaining power and a "better" pay package intends to continue his influence on the company after his retirement, he is more likely to persuade the board to not to pick an outsider as the new CEO. The reasoning behind this is that an outsider might have a greater bargaining power than insiders (Elsaid, etc., 2011) and shake the company with substantial changes in the board and management team. This big change might threaten the established authority of the departing CEO in the company. On the other hand, Davidson et al. (2008) find that corporate boards might by-pass relay succession and appoint an outsider with dual position of both Chairman and CEO when there is the need for a strong leadership and when the appointee has greater bargaining power. This will lower the likelihood that the departing CEO retains as a board director or becomes the Chair of the board in a normal succession. So according to these discussions, I develop the following hypothesis.

> *H3: When a departing CEO is entrenched with a better compensation package characterized with a greater cash and total pay at a lower risk, he is more likely to persuade the board to appoint an insider rather than an outsider as the new CEO of the company.*

Sample Selection and Variable Definitions

The *EXECUCOMP* database has the historical compensation data for the top executives of publicly-traded *S&P500*, *S&P Mid Cap*, and *S&P Small Cap* firms. I use this database to determine the year in which a CEO succession occurs from 1993 through 1998. A total of 1017 CEO successions during the sample period were identified at the first stage. Then the additional information about the CEO succession announcements was obtained from companies' proxy statements, news announcements on *Wall Street Journal*, and *Lexus Nexus* database. The companies that did not have available proxy statements or turnover announcements in the press, or had financial data in the *COMPUSTAT* database were dropped in the process. The sample selection process left 511 CEO succession announcements with complete information in the final sample. Table 1 shows the yearly distribution of the sample from 1993 to 1998.

There are seven categories of compensation data identified in the Summary Compensation Tables of annual proxy statements. They are salary, bonus, other annual compensation, restricted stocks awards, options and stocks appreciation rights, long-term incentive plan payouts (LTIP), and all other compensation. The sum of the seven components is reported as total compensation. Among these variables, other annual compensation is the dollar value of other annual compensation not properly categorized as salary or bonus, such as perquisites and other personal benefits. Restricted stock awards are shares granted to a manager subject to certain restrictions on the share sale until vested by the manager's continued employment in the company for a certain amount of time. Stock option grants are the aggregate value of stock options granted to the executive during the year as valued using S&P's Black-Scholes methodology. Long-term incentive payouts (LTIP) is the amount paid out to the executive under a company's long-term incentive plan, which measures company performance over a period of more than 1 year, generally 3 years.

Table 1. Sample Selection and Yearly Distribution

Year	*Number of CEO Successions*	*% of sample*
1993	29	5.7%
1994	71	13.9%
1995	116	22.7%
1996	88	17.2%
1997	107	20.9%
1998	100	19.6%
Total	**511**	**100.0%**

This table shows the yearly distribution of the sample. I first identify an initial sample of 1017 CEO successions listed in the EXECUCOMP database from 1993 to 1998. I obtain the information about departing and incoming CEOs from the *Wall Street Journal*, *New York Times*, *Washington Post*, etc. The final sample consists of 511 CEO succession announcements from 1993 to 1998.

CEO compensation risk used in this study is defined as the percentage of equity-based compensation, which consists of restricted stocks and stock option grants, relative to total compensation (Toyne et al. 2000). An alternative definition is the percentage of the sum of restricted stocks, stock option grants, and long-term incentive payouts (LTIP) relative to total CEO compensation. According to Ning et al. (2012), the Pearson Correlation coefficient for the two pay risk measures is as high as 98.2 % which is highly significant at 0.1 % confidence level, so I can use any of the two measures in the study.

Descriptive Statistics

The descriptive statistics of CEO and firm specific characteristics are reported in Table 2. Panel A shows the t test of the difference between the departing and incoming CEOs' compensation. The results indicate that the incoming CEOs are paid more in cash and in total than those for the departing CEOs. The average total compensation for the incoming CEO is $3,300 thousand dollars, which is significantly higher than the average pay $2,183.6 thousand dollars for the departing CEOs ($t = 3.3$, $p<0.01$). The finding is consistent with Elsaid and Davidson (2009), who find that boards and successor CEOs have an opportunity to redesign the predecessor's compensation contract when boards hire new CEOs. Their study find the total compensation of new CEOs in their sample increased by 69% over their predecessors.

I further find evidence that most companies are paying more for their new CEOs mainly through increasing the equity-based compensation ($1,941.6K vs. $878.8K, $t = 3.26$, $p<0.01$) which are closely tied to the stock performance of their companies, while only increasing cash pay ($1,040.7K vs. $997.9K; $t = 1.34$, insignificant) slightly. So the average risk level of the compensation is significantly higher for the incoming CEOs (38.63% vs. 27.37%, $t = 7.78$, $p<0.001$). This indicates that corporate boards intend to use the opportunity of CEO turnovers in their companies to redesign the CEO pay packages to align managerial incentives with shareholder interests. For example, boards offer a greater amount of compensation to attract high talent executives from inside or outside of the companies to be its new CEO, but set the risk of the new compensation package at a significantly higher level.

Panel A also displays some CEO characteristic. New CEOs are found to be younger (average 51.8 years old) compared to the former CEOs (60 years old), less likely to hold the dual positions of both the chair and CEO (47.2% vs. 75.9%), have a shorter tenure as the board director (3.7 years vs. 14.0 years), and own a much less stock holdings (2.6% vs. 5.8%). The t tests of differences for these CEO variables are mostly significant. These data provides evidence supporting the strong power of the departing CEOs given such factors as board tenure and CEO stock holdings can be used to measure CEO power, and the departing CEOs are likely to to use their power to influence the process of CEO successions at retirement.

Panel B in Table 2 reports the firm characteristics of the sample in Year -1 under the leadership of the departing CEOs and the same sample of firms in Year +1 under the leadership of the new CEOs, where Year 0 is defined as the year when the CEO turnovers occur. I find that, under the leadership of the new CEO, a company becomes significantly bigger in firm size measured by total assets, market capitalization, and sales in Year +1. The sample of firms also has a stronger financial position measured by a higher net income, return on equity, and stock performance. The firm value measured by Tobin's Q is only slightly up in Year +1, but not significantly different from that in Year -1.

Table 2. Descriptive Statistics of CEO and Firm Characteristics

Panel A: CEO Compensation and Characteristics:

Variables	Departing CEOs	Incoming CEOs	Mean difference	t-statistic
Cash compensation ($K)	997.9	1040.7	42.8	1.34
Equity-based compensation ($K)	878.8	1941.6	1,062.8	3.26***
Total compensation ($K)	2,183.6	3,300.0	1,116.4	3.27***
Compensation risk (%)	0.2737	0.3863	0.1126	7.78***
CEO age (%)	60.0	51.8	-8.3	-18.28***
CEO duality (%)	75.9	47.2	-28.7	-10.70***
Tenure as CEO (years)	9.2	--	--	--
Tenure as director (years)	14.0	3.7	-10.3	-23.46***
CEO stockholdings (%)	5.8	2.6	-3.2	-3.29***

Panel B: Firm Characteristics in Year -1 and Year +1

Variables	Year -1	Year +1	Mean difference	t-statistic
Total assets ($M)	4,913.7	5,537.7	624.0	2.23**
Market value of equity ($M)	3,976.5	5,306.2	1,329.6	3.69***
Sales ($M)	3,898.3	4,290.3	392.0	3.41***
Net income ($M)	162.6	221.6	59.0	2.16**
Return on equity (%)	6.9	9.9	3.1	1.41
1-Year stock return (%)	10.9	16.9	6.0	1.92*
Tobin's Q	1.8708	1.9012	0.0304	0.77

The table shows the descriptive statistics for CEO characteristics, CEO compensation, and firm variables in Year -1 during the leadership of the departing CEOs and Year +1 during the leadership of the incoming CEOs. Total compensation consists of salary, bonus, other annual compensation, restricted stocks awards, options and stocks appreciation rights (SARs), long-term incentive plan payouts (LTIP), and all other compensation. Cash compensation includes salary and bonus. Equity-based compensation consists of restricted stock rewards, and options and SARs. CEO Compensation risk is defined as the percentage of equity-based compensation relative to total compensation. CEO stockholding is the percentage of CEO shares to total shares outstanding. Net income is before extraordinary items and discounted operations divided by total common equity and return on equity is net income over total assets. Tobin's Q is the sum of the market value of equity and the book value of debt divided by the book value of assets. Significance at 10%, 5%, and 1% level is indicated by *, ** and *** respectively.

The Departing CEO Compensation across Firm/Industry Characteristics

Firm and industry specific variables, such as firm size, investment opportunities, and regulation, are found to have significant impact on CEO compensation, as documented in prior literature (e.g., Ning et al., 2012). Finkelstein and Peteraf (2007) argue that the greater the degree of the complexity and uncertainty of managerial activities, the higher the manager's discretion power which can be used to negotiate a "better" compensation package. Murphy (1998) indicates that large firms generally set the compensation for their top executives by comparing it with the compensation of peer group executives, and firm size is an important factor to select the peer group. Chung and Pruitt (1996) find that firm size has a significant impact on executive compensation. Palia (2001) reports that the structure of managerial pay is positively related to firm-specific characteristics, including firm size. In addition to firm size, a high-growth firm usually requires a more skilled CEO with a higher level of pay. The growth opportunity in a company can also strengthen the CEO's bargaining power. Smith and Watts (1992) investigate the executive pay and pay-for-performance sensitivity in a group of regulated and unregulated firms. They find that firms with greater investment opportunities hire more skilled executives who command both a higher level of pay and a stronger pay-performance relationship. Several other studies also report significant association between a firm's investment opportunities and CEO compensation (Core et al., 1999; Hartzell and Starks, 2003).

In this study, I define large firms as the ones with total assets greater than the median assets in the sample. Growth firms have a higher-than-median market to book ratio than the average. The regulated firms include financial firms (SIC 60-69), public utilities (SIC 49), and airlines and railroads (SIC 40~47) and the unregulated firms consist of all other companies in the sample. The empirical analysis of the departing CEO compensation structure across firm and industry characteristics are given in Table 3.

Panel A reports the departing CEO compensation across firm size. As expected, departing CEOs in large companies have a greater amount of pay in both cash and in total. The t tests of the

differences are highly significant (t= 13.39 and 10.48 respectively, p<0.001). The risk of CEO compensation, which is the equity-based compensation over total CEO pay, is 30.18% for the departing CEOs in the large firms, much higher than 24.48% for the departing CEO in the small firms (t = 2.55, p<0.05). This suggests that the departing CEOs in large firms generally have compensation packages at a higher level of risk compared to the departing CEOs in small peer companies.

Table 3. The Departing CEO Compensation across Firm and Industry Characteristics

Panel A: Departing CEO Compensation in Large vs. Small Companies:

	Large Firms	Small Firms	t-statistic
Cash Compensation	1428.3	565.8	13.39***
Total Compensation	3251.4	1111.60	10.58***
CEO Compensation Risk	0.3018	0.2448	2.55**

Panel B: Departing CEO Compensation in Growth vs. Value Firms:

	Growth Firms	Value Firms	t-statistic
Cash Compensation	1124.09	871.18	3.42***
Total Compensation	2559.22	1806.53	3.39***
CEO Compensation Risk	0.3152	0.2320	3.71***

Panel C: Departing CEO Compensation in Regulated vs. Unregulated Firms:

	Regulated Firms	Unregulated Firms	t-statistic
Cash Compensation	1033.29	992.45	0.37
Total Compensation	1795.83	2243.96	-1.72*
CEO Compensation Risk	0.2022	0.2850	-2.85***

Total compensation in the above table consists of salary, bonus, other annual compensation, restricted stocks awards, options and stocks appreciation rights (SARs), long-term incentive plan payouts (LTIP), and all other compensation. Cash compensation includes salary and bonus. CEO Compensation risk is defined as the percentage of equity-based CEO pay (restricted stocks and stock option grants) relative to total CEO compensation. Large companies are defined as the firms which have total assets greater than median. Growth firms have a higher-than-median market to book ratio. Regulated firms consist of financial firms (SIC 60-69), public utilities (SIC 49), and airlines and railroads (SIC 40~47).Significance at 10%, 5%, and 1% level is indicated by *, ** and *** respectively.

Panel B presents the amount and structure of departing CEO compensation in growth/value firms based on the classification of the market to book ratio. The departing CEOs in growth firms have a greater average of pay in cash ($1,124.1K vs. $871.2K) and in total ($2,559.2K vs. $1,806.5K) at a higher risk level (31.52% vs. 23.205) than that for the departing CEOs in value firms. The t tests of mean difference for all three compensation variables are highly significant at 0.1% or higher confidence levels. These findings are consistent with previous studies (Core et al., 1999; Hartzell and Starks, 2003). But the prior studies examine CEO compensation in general, not just the pay packages for departing CEOs in this study.

The analysis results of the departing CEO compensation across regulated and unregulated industries display a different picture, as shown in Panel C of Table 3. Regulated firms are classified as financial firms (SIC 60-69), public utilities (SIC 49), or airlines and railroads (SIC 40~47) companies. I find that while the cash pay for the departing CEOs in the regulated industries are higher ($1,033.3K vs. $992.5K), the total compensation ($1,795.8K vs. $2,243.9K) is lower (t = -1.72, p<0.1). The risk level of the departing CEO pay package in the regulated industries is 20.22%, which is also much lower than 28.50% in the unregulated firms (t = -2.85, p<0.01). These test results indicate that departing CEOs in the unregulated firms, which generally face a higher market competition than those regulated firms, are paid more by their boards for their more challenging work, but their pay packages are subject to a higher level of risk due to more restricted stocks and stock options included in their pay packages.

The Departing CEO Compensation and CEO Succession

The three hypotheses regarding the information content of departing CEO compensation around CEO succession announcements are tested in this section. I argue that when the departing CEOs are entrenched with a greater managerial power and use their power to negotiate a "better" compensation package for themselves, they are more likely to use their discretionary power to influence the process of the new CEO selections and continue their influences after retirements. The "entrenched" CEO power is measured by a "better" compensation package with a larger amount of cash and total compensation at a lower level of risk in this study. The test results are given in Table 4.

Panel A reports the test results for the departing CEO compensation in a routine CEO succession and in a non-routine succession. In a routine CEO succession, the departing CEO remains on the board as a director or becomes the chairman of the board after the mandatory retirement (Kang and Shivdasani, 1995). The results show that, in a routine succession, both the cash ($1,046.6K) and total compensation ($2,346.1K) for the departing CEOs are much higher than those ($901.3K in cash, $1,860.2K in total) of the departing CEOs in a non-routine succession. The t tests of the differences are both significant (t = 2.03 and 2.38 respectively, $p<0.05$). As hypothesized, the risk level of the pay package for the departing CEO is also much lower (26.93% vs. 28.41%) in a routine succession. These findings support H1 that when a departing CEO has a "better" compensation package characterized with a larger amount of pay at a lower risk, he is more likely to continue to remain on the board as a director or become the chairman of the board after retirement.

Table 4. The Departing CEO Compensation and CEO Succession

Panel A: Departing CEO Compensation in Firms with Routine vs. Non-routine CEO Turnover:

	Routine Turnovers	Non-routine Turnovers	t-statistic
Cash Compensation	1046.60	901.26	2.03**
Total Compensation	2346.11	1860.21	2.38**
Compensation Risk	0.2693	0.2841	0.56

Panel B: Departing CEO Compensation in Firms with Relay vs. Non-Relay CEO Succession:

	Relay Succession	Non-Relay Succession	t-statistic
Cash Compensation	1095.49	912.79	2.45**
Total Compensation	2196.49	2172.24	0.10
Compensation Risk	0.2477	0.2972	-2.16**

Panel C: Departing CEO Compensation in Firms with Incoming Outside vs. Inside CEOs:

	The incoming CEO is an outsider	The incoming CEO is an insider	t-statistic
Cash Compensation	752.27	1137.26	-5.06***
Total Compensation	1927.71	2328.94	-1.71*
Compensation Risk	0.3060	0.2557	2.06**

CEO turnover is the decision for a CEO to step down from the CEO position. I define routine CEO turnover as a mandatory retirement of the departing CEO becomes the chairman of the board or remains on the board as a director (Kang and Shivdasani, 1995). Relay succession is a process in which a company promotes the president or chief operating officer as the heir to the CEO. Significance at 10%, 5%, and 1% level is indicated by *, ** and *** respectively.

Panel B displays the departing CEO compensation across firms with relay or non-relay CEO successions. Relay succession is a process in which a company promotes its current president or chief operating officer as the heir to the CEO. The results in Panel B show that, in a relay succession, both the cash compensation ($1,095.5K) and total pay ($2,196.5K) for the departing CEOs are much higher than those ($901.3K in cash, $1,860.2K in total) for the departing CEOs in a non-relay succession. The t tests for the cash compensation difference is statistically significant (t = 2.45, $p<0.05$). I also find that the departing CEO compensation risk is much lower (24.77% vs. 29.72%) in a relay succession and the difference is significant at 5% confidence level (t = -2.16). The analysis results in Panel B support H2 that when a departing CEO has a "better" compensation package characterized with a greater amount of cash and total compensation at a lower risk, the departing CEO is more likely to favor relay CEO succession by promoting the company's current president and/or chief operating officer to be his successor. Since the president or COO was the former CEO's subordinate, it's easier for the departing CEO to continue to influence the new CEO as well as the company after his retirement.

In Panel C of Table 4, I examine the difference of departing CEO pay packages when the successors are outsiders and when the new CEOs are insiders. As the third hypothesis states, when a departing CEO is entrenched with a "better" compensation package characterized with a larger amount of pay at a lower risk, the CEO is more likely to favor promoting an insider rather than an outsider as the incoming CEO. The results in Panel C of the table are consistent with this hypothesis. I find that both the departing CEO's cash compensation ($752.K) and total pay ($1,927.7K) are significantly lower when the successor CEO is an insider than when the new successor is an outsider. The t tests for the differences are both significant statistically. The risk level of the departing CEO compensation is also found to be much higher (30.60% vs. 25.57%) when the new CEO is hired outside of the firm (t = 2.06, $p<0.05$). These results indicate that when the departing CEO is entrenched, he is more likely to use his negotiation power to persuade the board to choose an insider rather than an outsider as his successor at retirement.

Conclusions and Discussions

This study examines a sample of 511 CEO succession announcements to explore the amount and structure of departing CEO compensation from a unique perspective, the information contents of departing CEOs' incentive contracts for the incoming changes in corporate governance around CEO succession announcements.

The tests of the differences between the compensation for departing CEOs and incoming CEOs suggest that the new CEOs are generally paid more in a total, mostly through a significant increase of stock options, restricted stocks, and other long-term incentive plans. Therefore, the risk level of the pay packages for the incoming CEOs is significantly higher than that for the entrenched departing CEOs. This indicates corporate boards intend to use the opportunity of CEO successions to optimize their executive compensation structures to align it with shareholder returns. This optimization of CEO incentive contracts seems to be both beneficial to the new CEO and shareholders due to a growing firm size measured by total assets, market capitalization, and sales and a better financial situation characterized by a higher net income, ROE, and stock performance.

The amount and structure of the departing CEO compensation across firm and industry characteristics have also been examined in this study. Departing CEOs are generally paid more in firms with larger size and in firms with more growth opportunities measured by a higher market to book ratio. However, the incentive contracts for the departing CEO in those companies also incur a higher level of risk due to a higher proportion of stock options and other equity-related incentives in their pay packages. The departing CEOs in regulated firms (i.e., financial, public utilities, airlines and railroads) receive a higher cash pay, but a lower total compensation at a lower risk.

Most importantly, this study finds empirical evidence that is consistent with the notion of management entrenchment theory from a unique perspective - the departing CEO compensation around CEO successions. If a departing CEO is "entrenched" with a greater discretionary power and negotiates a "better" compensation package characterized with a greater amount of pay in both cash and total at a lower risk, he is more likely to retain on the board as a director or hold the title of board chairman after his retirement. There is also evidence that when the departing CEO is entrenched with a greater discretionary power and a better pay package, he is more likely to persuade the board to nominate an insider rather than an outsider to be the successor CEO, and support the promotion of the company's current president and/or chief operating officer to be his successor. These findings support the hypotheses in this study that the entrenched CEOs intend to use various means to continue their influences on the company even after they retire from the top position of their companies.

The contribution of this study is to examine CEO compensation, a hot topic in the corporate governance literature, from a unique perspective- the departing CEO compensation. I identify valuable information from the departing CEOs' pay packages which can signal the incoming CEO succession process and corporate governance changes in a company. This gives academics and practitioners a different view regarding how departing CEOs influence the CEO succession process of their companies. This is also valuable for shareholders and regulators in the real business world given the fact that SEC argues that CEO succession planning raises a significant policy issue regarding the governance of the corporation, so it enacted a new rule in December 2012 to allow shareholders to make proxy proposal on CEO succession planning for their companies.

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