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This is the final peer-reviewed author's accepted manuscript (postprint) of the following publication:

Published Version:

Availability:

This version is available at: <https://hdl.handle.net/11585/895072> since: 2023-02-16

Published:

DOI: <http://doi.org/10.1504/ijbge.2022.10052221>

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This is the final peer-reviewed accepted manuscript of:

**Petracci, B., Pattitoni, P., & Hafaïedh, C. B. (2022). Egregious separation payments
The role of internal and external corporate governance.**

The final published version is available online at:

<https://dx.doi.org/10.1504/ijbge.2022.10052221>

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Egregious Separation Payments? The Role of Internal and External Corporate Governance

Abstract

Egregious, unfair, unethical, and immoral are all adjectives that the public and shareholder activists use to describe separation payments, which are payments made to executives who leave firms for various reasons. Such complaints often cite corporate governance issues as well, noting the potentially problematic relationships between executives' and board members' compensation levels. However, some studies of separation pay agreements suggest a lack of any significant relationship between the quality of corporate governance and separation payments. Using a unique, hand-collected data set pertaining to actual payouts received by the top executives who left their posts between 2002 and 2013 in Italy, this study reveals instead that better quality corporate governance, in both internal and external dimensions, helps regulate the level of separation payments. In turn, it can offset stakeholders' perceptions of unfairness and the resulting negative consequences for the firm; such governance also can help minimize the prevalence of pay-for-failure cases.

Keywords: boards; corporate governance; ethics; executive compensation; separation payments.

Introduction

When executives at the biggest companies are hired, they often negotiate contracts that are likened to prenuptial agreements, in which the CEO is guaranteed a handsome payout if the relationship goes south and results in a divorce (Tuttle, 2015).

Corporate boards insist that separation payments, which are the payments made to executives when, for whatever reason, they leave their firm (Yermack, 2006)¹, are important executive compensation tools, enabling them to recruit better executives. By insuring this human capital, the executives have stronger incentives to take risks for the firm (Meridian Compensation Partners, 2015). Furthermore, separation payments align with the boards' role as shareholder protectors (Klein *et al.*, 2017). Despite this claim, some researchers assert that weak boards offer larger separation payments than strong boards (Almazan and Suarez, 2003), implying managerial rent extraction (Bebchuk and Fried, 2004), in the sense that executives might take advantage of weak corporate governance settings. Nevertheless, most empirical studies find that separation payments are in line with firms' best interests. However, these studies generally focus on *contractual* separation payments rather than *actual* payouts, even though, as Goldman and Huang (2015) explain, "discretionary separation pay is given to about 40% of departing CEOs."

Considering these factors, we manually collect a unique data set of separation payments in Italy to examine the precise relationship of corporate governance with actual separation payments. With this novel approach, we determine that separation payments exhibit a negative relationship with high-quality internal corporate governance. Furthermore, firms' governance as captured by ownership characteristics associates with separation payments too. Finally, we

¹ Other authors use various terminologies, such as severance instead of separation. Although originally used to refer to payments following voluntary and involuntary termination, researchers have applied it to different types of terminations, such as changes in control (Klein *et al.*, 2017). Some terminations take specific terms too, such as golden handshakes to designate involuntary termination (Yermack, 2006) or golden parachutes for change-in-control agreements (Fiss *et al.*, 2012). We use the generic term "separation" but distinguish carefully between a separation payment agreement or contract (ex-ante) versus the actual payout (ex-post).

find that the corporate governance regulatory environment is linked to separation payments as well.

Our findings fill an important gap in separation payment literature—a form of executive compensation that has largely flown under the radar (Klein *et al.*, 2017). By focusing on termination payouts rather than initial agreements, our study offers a potential explanation for the mixed results in prior separation payment literature (Klein *et al.*, 2017). Moreover, our findings contribute to corporate governance literature by confirming the importance of quality indicators in setting separation payments (Bebchuk and Fried, 2004, Bebchuk *et al.*, 2002), which has not been addressed by research focused on ex-ante agreements (Klein *et al.*, 2017, Rusticus, 2006). Our research also goes beyond internal corporate governance practices and highlights the importance of external corporate governance as well. Illuminating the relationship of corporate governance with actual separation payments can offset stakeholders' perceptions of unfairness and the resulting negative consequences for the firm; such governance also can help minimize the prevalence of pay-for-failure cases.

In the next section, we thus examine perceptions of unfairness surrounding separation payments, as well as the claimed economic rationales for such payments. We then develop our hypotheses about the relationship between corporate governance and separation payments, and introduce the institutional setting of our study. After presenting the methodology and the results, we discuss the latter and their implications. We conclude by outlining limitations to our study and offering avenues for future research.

Separation Payments: Perceived Unfairness and Economic Rationales

The public and shareholder activists are increasingly appalled by vast separation payments offered to executives, which they describe as unfair, unethical, and immoral (Cowen *et al.*, 2016, Croci *et al.*, 2012, Rau and Xu, 2013). Large separation payments evoke strong

perceptions of unfairness, which in turn threaten negative consequences for the firm and its performance. For example, employee motivation and commitment decline (Cowen *et al.*, 2016), and lower-level managers even might express heightened turnover intentions (Wade *et al.*, 2006). Moreover, because they reflect organizational values and ethics, “people inside and outside of organizations are concerned about matters of fairness in compensation systems even when they have no direct implications for their own pay and rewards” (Bloom, 2004). This is in line with the stakeholder model of governance (Dessain *et al.*, 2008).

Most large separation payments that generate public indignation arguably involve pay-for-failure scenarios (Rau and Xu, 2013). Perel (2003) argues that when failed executives receive large separation payments, it draws media attention, regulatory scrutiny, and shareholder anger, because it implies rewards for failure, which “can have a deleterious effect on employee morale as well as on shareholder regard for the offending firm” (Perel, 2003). The effects of such perceived unfairness then are heightened because the decisions appear not only unfair but immoral (Bloom, 2004), so they threaten to “reduce employees’ motivation on the job and promote dysfunctional behaviors that undermine an organization’s long-term growth and profitability” (Cowen *et al.*, 2016).

Yet boards of directors still resort to separation payments, with the argument “that they serve as an important tool for executive recruitment and corporate governance” (Cowen *et al.*, 2016). A consultancy’s survey of executive separation arrangements, across a cross-section of 160 companies from Standard & Poor’s 500 Index, revealed the prevalence of the following business rationales: being able to attract superior executive talent by insuring executives against termination risk and providing competitive compensation; being able to retain executives during turbulent times; and avoiding negative consequences for the company following the departure of the CEO (e.g., by securing restrictive, non-compete, or non-solicitation covenants) (Meridian Compensation Partners, 2015). Alternatively, however, they

might be perceived as a form of expropriation, at the expense of shareholders, that go beyond the principle of a “fair day’s wage for a fair day’s work” (Bloom, 2004) and that increase rather than mitigate agency problems (managerial rent extraction theory). Yermack (2006) identifies some evidence in support of the business rationales but also notes that his results align with a weak governance perspective. Goldman and Huang (2015) find that discretionary separation pay, which reflects the difference between the contractual and the actual amounts of separation pay, positively correlates with having a non-compete clause in the ex-ante severance contract. They also cite weak governance theory in analyzing discretionary separation payments.

Of note, both Yermack (2006) and Goldman and Huang (2015) consider payments at termination, whereas other studies focus on prior separation payment agreements. This latter line of research generally indicates that separation payments align with the boards’ declarative rationales (e.g., Brown *et al.*, 2015, Cadman *et al.*, 2011, Ling, 2012, Manso, 2011, Rau and Xu, 2013).

Corporate Governance: Possible Regulator

Corporate governance mechanisms arguably help regulate separation payments, especially in the absence of explicit legal limits to these payments. Starting with a foundation in managerial rent extraction theory, we anticipate that executives have more or less power to extract at least some rent, depending on the quality of the firms’ corporate governance system (Bebchuk and Fried, 2004, Bebchuk *et al.*, 2002).

While corporate governance research cautions against the idea that “good” and “bad” governance practices exist in absolute (Brickley and Zimmerman, 2010), research did nonetheless identify some corporate governance practices whose effects are more predictable than others (Elston, 2019), and on which codes of good governance worldwide rely (Aguilera *et al.*, 2019). For example, corporate governance quality generally appears lower if the CEO

also chairs the board (i.e., duality) (Broye *et al.*, 2017, Chen *et al.*, 2007, Rechner and Dalton, 1991, Sarim, 2020) because the combination of titles leads to increased power over the board (Goyal and Park, 2002) and corporate decisions (Adams *et al.*, 2005). Rent extraction in the design of executive compensation is thus facilitated (Bebchuk *et al.*, 2002). Furthermore, corporate governance codes and research invite to embrace “the virtues of few directorships” (Bar-Hava *et al.*, 2013) despite the argument that multiple directorships give these members more experience and access to critical resources (Kiel and Nicholson, 2006). Indeed, even the latter can have an adverse effect when executives serve on outside boards of companies in unrelated industries (Clements *et al.*, 2015) and/or when the most important board function is monitoring, as for separation payments regulation, rather than advising. Building on agency arguments, multiple directorships can compromise these board members’ duty of care (Latif *et al.*, 2020) because of their busyness notably (limited time and attention due to over-commitment) (Mazzotta *et al.*, 2017). Moreover, in the case of separation payments, it is arguable that corporate governance is stronger if compensation committees exist, responsible specifically for reviewing the adequacy and form of the directors’ compensation (Catuogno *et al.*, 2016, Conyon and He, 2011, Sun *et al.*, 2009). Governance quality also tends to be higher if executives are subject to clawback provisions (Chan *et al.*, 2015, Iskandar-Datta and Jia, 2013), defined as clauses that allow for separation payment withholding if the relationship between the executive and the firm ends due to negative performance or misconduct (like, for example, when an executive manipulates accounting reports). We thus predict:

H1a – Separation payments are higher in case of duality.

H1b – Separation payments are higher in the case of multiple directorships.

H1c – Separation payments are lower when compensation committees are present.

H1d – Separation payments are lower when executives are subject to a clawback provision.

As another key dimension, we consider the ownership structure, which strongly influences potential corporate governance issues (de Miguel *et al.*, 2004, La Porta *et al.*, 2000). That is, corporate governance relates to firms' ownership structure (Chen *et al.*, 2007), especially the identity of the majority shareholder (Wu, 2006), to the extent that we must acknowledge "codes designed for companies with a specific ownership structure" (Cuomo *et al.*, 2015). Ownership structure influences monitoring activities and can thus impact separation payments (Uhlener *et al.*, 2007). Family businesses, in particular, seek to employ family members, even if a more professional executive team would be beneficial, and this priority can be detrimental to corporate governance quality (Jouirou, 2021, Klonowski, 2015, Wu, 2006). Barontini and Bozzi (2011) show that Italian family firms pay their CEOs more than other firms; family CEOs typically are paid more than professional CEOs. Barak *et al.* (2011) provide similar evidence in Israel. In contrast, significant government ownership is associated with more monitoring and voluntary disclosures signaling better corporate governance quality in state-owned firms (Bae *et al.*, 2019, Eng and Mak, 2003). Finally, consistent with the literature that points out, with nuances, the monitoring role of institutional investors (e.g., Aggarwal *et al.*, 2011, Chung and Zhang, 2011, Ferreira and Matos, 2008, Parrino *et al.*, 2003), we expect their presence among the firm's shareholders to improve corporate governance quality (Khanchel, 2007). Bebchuk *et al.* (2002) argue that, all else being equal, executives tend to have more power in the presence of fewer institutional investors, and Hartzell and Starks (2003) find that more concentrated institutional ownership implies lower executive compensation. We thus predict:

H2a – Separation payments are higher for family firms.

H2b – Separation payments are lower for state-owned firms.

H2c – Separation payments are lower when institutional investors are present among firm shareholders.

These predictions refer to internal drivers of corporate governance that may affect separation payments, but we also note that firms do not operate in a vacuum, and the surrounding environment may be more or less conducive to good corporate governance practices (Aguilera *et al.*, 2015). Also, compensation reports are considered good practices in international corporate governance codes (Cuomo *et al.*, 2015), and such good practices may be enforced more or less strictly. If governments apply more pressure on firms to follow good practices (external corporate governance), the comparative advantages of quality-improving board characteristics (internal corporate governance) diminish, in that good governance represents the norm rather than the exception (Aguilera *et al.*, 2015). Therefore, we predict:

H3. Regulatory standards that promote good corporate governance practices reduce the effect of quality-improving board characteristics on separation payments.

Furthermore, this pressure can come in many forms. The European Union (EU) approach highlights the “comply or explain” rule, which “requires listed companies to comply with the regulations or otherwise to disclose and explain to the shareholders (e.g., in the annual report) the reasons for non-compliance” (Soltani and Maupetit, 2015). Soltani and Maupetit (2015) discuss the shortcomings of this method in the European context, the main one being the lack of sanction for non-compliance. Rose (2016) finds a positive link between the degree of Danish firms’ comply or explain disclosure scores and firm performance but also notes the necessity to be more active in penalizing poor explanations and/or wrongful compliance. We also note the potential for some nuance, even in hard laws. Stricter regimes, such as those that require binding rather than advisory votes by shareholders on compensation, may contribute to stronger regulations of separation payments too. We thus predict:

H4. Separation payments are lower when good corporate governance practices are binding rather than advisory.

Institutional Context

We examine the above hypothesized relationships among internal and external corporate governance and separation payments in Italy. This country is a very relevant setting in this instance notably because of Italian firms' specificities: a high ownership concentration, pyramid ownership formation, a significant presence of holding companies, family firms, and state-owned enterprises (Belcredi *et al.*, 2014, Melis, 2000, Zattoni, 2006). The board members of Italian listed companies are often top managers who represent the controlling shareholder or people linked to the main shareholders through family or professional relationships (Volpin, 2002). In this context, the traditional agency conflicts between shareholders and managers become agency conflicts between controlling shareholders and minority shareholders, the independence of outside directors is not guaranteed, and small investors are weakly protected (D'Onza *et al.*, 2014). Since the mid-1990s, many new rules have been introduced to protect small investors in Italy, such as the so-called Draghi reform (1998), the "Corporate Governance Code" (Codice Preda 1999), the new company law (2003), the "Savings Law" (2005), and the Legislative Decree n. 259/2010, entered into force in 2011. The latter requires that (1) shareholders express an advisory vote on their firm compensation policies and (2) that firms provide a periodic standardized executive compensation report. Furthermore, concerning the vote on compensation policies, a special and stricter regime is provided for financial firms. In 2011, the Bank of Italy and the Italian Insurance Supervisory Authority (IVASS) establish that shareholders of financial institutions can express a binding vote on the compensation policies of their firms. Thus, the vote on compensation policies expressed by shareholders is advisory for non-financial firms and binding for financial firms.

In summary, when focusing on executive compensation, Italy represents an ideal study setting for two main reasons. First, as agency problems could be heightened (Zona, 2014) in Italy, this country lends itself well to an examination of how internal corporate governance

quality enhancements might help regulate separation payments. Second, an important regulatory change took place during our study period (Belcredi *et al.*, 2014), which provides a natural setting in which to test the hypotheses pertaining to external corporate governance.

Methodology

Sample and Data Sets

We hand-collected a unique data set of information about top executives who left their posts between 2002 and 2013 in Italy for various reasons. Our sample is composed of 74 observations (38 companies). This sample size reflects our investigation of actual payments rather than ex-ante agreements, and is comparable with the number of observations in similar prior studies (e.g., Yermack, 2006).

The list of executives included in this data set came from the yearly column, “Pay Watch,” published by *Il Sole 24 Ore*, the main Italian financial newspaper, which reports the 50 highest-paid executives each year, in terms of ordinary compensation and separation payments.² Managers leaving their posts receive both, and the latter payments are disproportionately higher than ordinary compensation in Italy (6 to 7 times higher; Assonime, 2015)³, so managers leaving their posts are very likely to be included in this list (cf. managers receiving their ordinary compensation solely). In fact, the list considers all listed companies in which managers already receive very high ordinary compensations. Even if a manager ended up off the list because of a very low ordinary compensation and separation payment, that case would be more of an outlier than a case worth considering, given our object of analysis (i.e., egregious separation payments). We thus believe that, while imperfect, this column provides a

² After hand-collecting the amount paid in favor of executives from *Il Sole 24 Ore*, we have double-checked all our values with those reported in the corresponding firm annual compensation report.

³ Assonime is the Association of Italian joint-stock companies, which studies firms and markets in Italy.

reliable source of managers who receive separation payments, which reduces the risk of selection bias.

For each executive in the list who received a separation payment, we hand-collected individual- and firm-level data from several sources. The separation payments were listed in executive compensation reports and financial statements, so we obtain actual payments, not ex-ante contractual provisions (see Goldman and Huang, 2015). We obtained the individual-level data from executives' profiles on company websites or other online sources. Data about the board characteristics and ownership structures came from yearly corporate governance reports and the Italian Companies and Exchange Commission (Consob) website. Finally, we obtained additional firm-level data from Refinitiv Eikon (Eikon).

Measures

Separation payments

Our empirical analysis includes two measures of separation payment as dependent variables. The first is the natural logarithm of the ratio between the total separation payment amount⁴ received by the executive leaving the firm and the number of years spent working in the firm.⁵ There are two main reasons to log transform this variable. First, the coefficients can be interpreted as elasticities or semi-elasticities, that is, the percentage change of the dependent variable following a unit change in the independent variable, solving scale issues. Second, log transformation typically mitigates heteroscedasticity problems that are very likely with unit-level cross-sectional data.

The second variable is the natural logarithm of the compensation ratio, equal to the ratio of total separation payment to the non-variable component of annual compensation. An advantage of this variable over the simplest separation payment measure is that normalizing for annual

⁴ This amount does not include non-disclosure agreements, non-competition clauses, and media/life insurances.

⁵ While several authors show that separation payments and director tenures may be related (Blackwell *et al.*, 2007, Nourayi and Mintz, 2008, Webb, 2008), the results of the empirical analysis are very similar if we do not divide the separation payment by the number of years.

compensation helps reduce heterogeneity in separation payments. This measure is inspired by Recommendation n.2009/385/EC that suggests calculating the ratio of the separation payment to the variable compensation of the last two years and keeping this ratio under 2. In our data set, the ratio suggested by Recommendation n.2009/385/EC exceeds the threshold value of 2 about one half of the time. At this point, it is worth emphasizing that, in contrast with the European directive, the Italian regulation requires this ratio not to overcome a threshold without identifying a specific value for it.

Corporate governance

As explanatory variables to test H1 (a-d), we consider the board-characteristic dimension with four measures. The first measure is CEO duality that we operationalize as a dummy variable as widely spread in corporate governance studies (Gove *et al.*, 2017). More precisely, duality equals one whether the annual corporate governance report indicates that the CEO also chairs the board (duality; 7% of observations; Ryan and Wiggins, 2004). Gove *et al.* (2017) show that a dichotomous approach to CEO duality as ours may be acceptable in Italy as most of the Italian companies (83%) meet the stability criteria (no change from duality to non-duality and vice versa) in the period they investigate, 2002-2012, which substantially coincides with our analysis period. Our second measure is a dummy variable that equals one if the executive serves on the board of any other firm during the last year when the relationship with the firm has interrupted (multiple directorships; 47% of observations; Renneboog and Zhao, 2011). Our definition refers to current directorships without considering past multiple directorships and neglects the type of correlated firms (for example, if they belong to the same network). Our third dummy variable equals one if the firm has a compensation committee (79% of observations; Laux and Laux, 2009). A fourth dummy variable equals one if a clawback provision is included in the ex-ante contractual agreements between the executive and the firm

(12% of observations; Fried and Shilon, 2011). The information about all these four variables come from corporate documents.

A second set of three variables, obtained from the Consob website and the annual corporate governance reports approved in the first quarter of the year following the executive departure, pertains to the ownership-structure dimension and is used to test H2 (a-c). The first dummy variable equals one if the shareholder with the highest amount of voting rights is a family (family firm; 26% of observations⁶; Barontini & Bozzi, 2011). More precisely, collecting the voting rights of the biggest ten shareholders, according to Chua *et al.* (1999) we define a family firm if the shareholder with the highest ownership (that can be lower than 50%) is a physical person belonging to the family or a holding close to the family.

Our second ownership dummy variable equals one if the shareholder with the highest amount of voting rights is the state (state-owned firm; 16% of observations; Barontini and Bozzi, 2011). Our third ownership dummy variable equals one if private institutional investors are among the firm shareholders (87% of observations; Croci *et al.*, 2012). Concerning this last variable, we do not take into account the amount of voting rights, but only the presence of institutional investors because, as emphasized by Gillan and Starks (2003), independently of how different types of owners interact, they will increase the liquidity, volatility, and price informativeness of the companies included in their portfolios. Therefore, the increased information provided by institutional trading should generate better monitoring of firms and encourage better corporate governance practices.

Beyond these internal forms, we consider external corporate governance. We use the regulatory change introduced in 2011 concerning Italian financial firms to test H3 and H4, with a dummy variable that indicates if the executive left their post after 2011 (22% of observations).

⁶ The percentage of family firms is seemingly low, compared with other studies (see, for example, Kirchmaier and Grant, 2005). However, Assonime (2015) documents that separation payments are less frequent in family firms, for which control tends to be more stable and family CEOs enjoy other guarantees.

Controls

We include several individual- and firm-level control variables. At the individual level, we use (1) a dummy variable to indicate if the person leaving is a managing director (44% of observations), (2) the natural logarithm of the executive's base compensation in the year preceding the separation (mean before logs = 0.99 mln €; Yermack, 2006), (3) the length of the executive's tenure in the firm in years (mean = 7.16; Cao and Wang, 2013, McKnight and Tomkins, 2004), and (4) the natural logarithm of the executive's age (mean before logs = 59.55; Rau and Xu, 2013). Whereas tenure, especially CEO tenure, is associated with managerial entrenchment (Berger *et al.*, 1997, Rose and Shepard, 1997), age is a proxy for human capital. These two aspects are linked to compensation (Abdel-khalik, 2003, Berger *et al.*, 1997, O'Neill, 1990).

Among firm-level variables, we consider (1) the market-to-book ratio as a measure of firm growth (mean = 1.45; Croci *et al.*, 2012), (2) the ratio of long-term debts to total assets as a measure of leverage (mean = 0.51; Yermack, 2006), (3) the natural logarithm of firm market capitalization as a measure of size (mean before logs = 19338 mln €; Croci *et al.*, 2012, Yermack, 2006), (4) two measures of risk (specific risk, mean = 0.26, and systematic risk, mean = 0.22; Cao and Wang, 2013),⁷ and (5) a dummy indicator of whether the firm is a financial institution (43% of observations; Yermack, 2006). All firm-level variables come from Eikon, recorded at the end of the year preceding the separation.

Finally, we include a dummy variable, equal to 1 if the executive left the post during 2007–2009 (33% of observations). This dummy variable acts as a control for potential time heterogeneity due to macro-level effects associated with the financial and economic crisis.

⁷ To obtain the two risk variables, we use an approach similar to that of Anderson and Fraser (2000) and Demsetz and Strahan (1997), such that we regressed the returns of each firm on the returns of the market index. With the results, we divide the total variance of the returns into an explained systematic part and an unexplained specific part.

Definitions, descriptive statistics and a correlation matrix for all variables are in Tables 1, 2, and 3, respectively.

Insert Tables 1, 2, and 3 about here.

Empirical models

We use regression analyses to test the hypotheses. For H1 (a-d) and H2 (a-c), the dependent variable (separation payment or compensation ratio) is designated y_i , and the stochastic error term uses ε_i , so the empirical model is

$$y_i = \beta_1 \text{Duality}_i + \beta_2 \text{MultDir}_i + \beta_3 \text{CompComm}_i + \beta_4 \text{Clawback}_i + \omega_1 \text{FamFirm}_i + \omega_2 \text{StateFirm}_i + \omega_3 \text{InstInv}_i + \boldsymbol{\kappa}' \mathbf{c}_i + \varepsilon_i, \quad (1)$$

where \mathbf{c}_i is a vector of individual- and firm-specific control variables. In Equation 1, the β s, ω s, and the elements of $\boldsymbol{\kappa}$ (1-11) are the parameters to be estimated. We base inference on robust firm-clustered standard errors to take into account that some companies have multiple observations even if they are time-spaced events. For our empirical strategy, testing H1 (a-d) and H2 (a-c) amounts to testing the sign and significance of the β and ω coefficients, as we detail in the next section.

We test H3, using an augmented version of the model in Equation 1 that includes interactions between the dummy variable indicating when the executive left the post (i.e., after 2011, when several regulatory changes occurred) and the board characteristic variables.

The test for H4 relies on a difference-in-difference–like approach, with the following general model:

$$y_i = \pi_1 \text{Post2011}_i + \pi_2 \text{Financial}_i + \pi_3 \text{Post2011} \times \text{Financial}_i + \boldsymbol{\omega}' \mathbf{z}_i + \varepsilon_i, \quad (2)$$

where Post2011 is a dummy variable that refers to the period after the introduction of several regulatory changes, Financial is the dummy variable that indicates firms for which regulatory changes introduced binding (cf. advisory) good corporate governance practices (financial

firms), and \mathbf{z}_i is a vector of control variables that include those used in the previous models, as well as board-specific and ownership-specific explanatory variables. In Equation 2, the π s are parameters, and ω is a vector of parameters.

After controlling for the variables included in \mathbf{z}_i , the coefficient π_1 may be interpreted as a time trend, common to firms for which good corporate governance practices are both advisory (non-financial firms) and binding (financial firms). The coefficient π_2 accounts for all permanent differences between non-financial and financial firms, and π_3 measures the effect of the special, stricter regime on executive compensation, using solely financial institutions in the post-2011 period. Therefore, π_3 is the coefficient of interest for testing H4.

Results

Table 4 reports four regression models: Models 1 and 2 for the separation payment and Models 3 and 4 for the compensation ratio.⁸ Models 1 and 3 are full models that include all explanatory and control variables, such that they are demanding in terms of degrees of freedom. Although our data set includes the population of managers receiving separation payments from Italian companies, the total number of observations, comparable to similar studies (e.g., Yermack, 2006), is small in absolute terms. To improve the efficiency of our estimates, we provide the results of restricted models, chosen according to a general-to-specific selection procedure (Verbeek, 2012) based on a stepwise algorithm that includes subsets of the most significant control variables. Therefore, the restricted Models 2 and 4 include all explanatory (governance and ownership) variables but only the control variables with p -values lower than .2 in the vector \mathbf{c}_i . The significance level of .2 represents a compromise between the desires to improve efficiency by including only relevant variables and to preserve consistency by avoiding the omission of relevant variables.

⁸ A VIF analysis on the full models reveals that multicollinearity is not an issue in our analysis.

The results in Table 4 are mostly consistent with the groups of hypotheses H1(a-d) and H2(a-c), even if some results are only marginally significant. The relationship between duality (H1a) and separation payments (compensation ratios) is positive, albeit slightly significantly so only in Models 1, 2, and 4. Separation payments and compensation ratios tend to be higher in cases marked by multiple directorships (H1b). All models exhibit significant and positive coefficients, ranging from 0.40 to 0.80. The interpretation is straightforward in terms of semi-elasticities. Consider Models 1 and 2: separation payments are 48% (Model 1) or 40% (Model 2) higher in case of multiple directorships. Compensation committees (H1c) are negatively linked to compensation ratios (see the negative coefficients of Models 3 and 4). The clawback provision (H1d) has no significant effects in any model. Family firms (H2a) tend to pay higher separation payments. For example, family firms tend to pay separation payments from 36% to 40% higher than non-family firms. This effect is more significant when considering compensation ratios, though (the effect is marginally significant in Models 1 and 2 and strongly significant in Models 3 and 4). On the other hand, state-owned firms (H2b) pay lower separation payments. This effect is strongly significant, but we find no effects on compensation ratios. Finally, institutional investors (H2c) have negligible effects in all models, probably due to the widespread presence of institutional investors in the sample (87% of observations), which reduces variability in the sample and makes estimates of this coefficient less accurate.

Insert Table 4 about here.

In Table 5, consistent with H3, the coefficients of the interaction terms with the compensation committee and multiple directorships dummy variables are positive and significant, suggesting a positive moderating effect of the post-2011 dummy variable. In other words, regulatory standards promoting good corporate governance practices reduce the positive relationship of quality-improving board characteristics and separation payments. The interaction term with the clawback dummy variable is never significant. Regarding the role of compensation

committees, the result seems to explain the weakly negative results in Table 4 as a result of the post-2011 effect. The interaction term with the duality dummy variable is omitted because there are no cases of duality in the post-2011 period.

Insert Table 5 about here.

Then we test H4. As expected, π_3 is negative and significant in both regression models (albeit it is only slightly significant in Model 1). The results in Table 6 are thus consistent with H4. Providing a graphical representation, Figure 1 helps better understand the decrease in separation payments recorded in financial firms after the reform entered in force in 2011. As can be seen from the figure, both the separation payments and the compensation ratio decreased significantly in 2011 compared to their previous value for financial companies (dashed line, triangle marker). On the other hand, the values remain approximately unchanged for non-financial firms (full line, circle marker).

Insert Table 6 and Figure 1 about here.

Discussion

Separation payments are important components of compensation systems that can be perceived as either “the result of a market-based mechanism which ensures that managers have adequate incentives to maximize shareholder value” or “a means whereby self-serving executives skim corporate profits and expropriate shareholders” (Goergen and Renneboog, 2011). Both options relate intimately to corporate governance, either as rather effective or quite weak (Goergen and Renneboog, 2011). Noting public outrage at large separation payments, we use this situation as a motivation to investigate solutions. By exploring the relationship between corporate governance mechanisms and separation payments, we arrive at several prescriptions for how corporations can mitigate the risks predicted by managerial rent extraction theory (Bebchuk and Fried, 2004) and minimize this perceived injustice.

We find that corporate governance features (board characteristics, firm ownership) that tend to be positively or negatively associated with corporate governance quality correlate with separation payments overall. On the one hand, separation payments tend to be lower when compensation committees are present and for state-owned firms. On the other hand, separation payments tend to be higher in cases of duality, multiple directorships, and family firms. The relationship of internal corporate governance with separation payments contrasts with Rusticus (2006) finding of “no relation between severance agreements and other commonly used proxies for governance mechanisms,” but it also reflects the different focus of our study on actual payouts instead of contractual (ex-ante) separation payments. In so doing, we confirm and extend the results of two other studies that move beyond ex-ante agreements. Yermack (2006) finds that a large majority (83%) of separation payments are discretionary, awarded by the board of directors and not according to the terms of existing employment agreements. His study brings support to managerial rent extraction theory. Goldman and Huang (2015) find that discretionary pay, that is the difference between the agreement and the actual payout, correlates with weak internal governance in cases of voluntary CEO turnover. For this study, we purposefully investigate actual payouts, without considering the ex-ante agreement (i.e., without deducing contractual separation pay), because it is the actual payouts that are widely publicized and deemed unfair, notwithstanding the initial agreement. This difference might also explain why Goldman and Huang (2015) results do not hold when the CEO is forced out. Moreover, we identify the influences of other board characteristics (duality, multiple directorships) and firm characteristics (family firm, state-owned).

This study also outlines the effects of external corporate governance, extending “corporate governance research [that] has largely focused on internal governance mechanisms (i.e., the board of directors, controlling owners, and managerial incentives)” (Aguilera *et al.*, 2015). It is critical, according to our findings; regulatory changes that promote good corporate

governance practices reduce the regulatory effects of internal corporate governance practices. Moreover, hard laws and stricter regimes, such as requirements of binding rather than advisory shareholder votes on compensation, positively contribute to the regulation of separation payments. It is thus interesting to note that on June 10th, 2019, Italy transposes the new EU directive SRD II (n. 2017/828/EU, so-called Shareholder Rights Directive), which converts the Say-On-Pay vote on the remuneration policy from an annual advisory vote to a mandatory triennial one, while introducing an advisory vote on the remuneration report.

Implications

Our findings, in turn, offer three main implications. First, this research contributes to the emerging body of literature on separation payments as a form of executive compensation that has largely been ignored (Klein *et al.*, 2017). That is, existing research tends to focus on initial agreements and shows how they align with shareholders' interests, but by investigating actual payments at termination, we offer support for managerial rent extraction theory (Bebchuk and Fried, 2004). Powerful executives use their bargaining power to obtain large separation payments "beyond the value of their human capital" (Yermack, 2006). Therefore, actual payouts need to be studied in their own right.

Second, we contribute to corporate governance literature by confirming the importance of quality indicators as they relate to actual payouts, not just ex-ante agreements (Klein *et al.*, 2017, Rusticus, 2006), as well as by considering external corporate governance together with internal corporate governance (Aguilera *et al.*, 2015).

Third, this research contributes to the highly relevant considerations of important issues such as executive compensation, and separation payments, according to a broader perspective than just an economic view (Joutsenvirta, 2013). Yermack (2006) notably concludes his study of separation payments with the line, "All of these patterns suggest that certain norms of equity or fairness influence firms' decisions about how to compensate exiting CEOs, without clear

attention to any theory of economic optimization.” However, a lack of ethical considerations in compensation schemes is evident (e.g., Harris, 2009, Joutsenvirta, 2013). We take public outrage and perceived unfairness as a departure point to investigate what might be done; continued research should keep working to bridge the streams of business and society to address the highly controversial component of executive compensation represented by separation payments.

Limitations and future research directions

The sample and the institutional context are the first opportunities for discussing limitations and future research avenues. We contend that the sample includes the total population of managers leaving their posts, but it could be argued that the sample is rather biased toward high-profile cases. In the methods section, we explain why we do not believe it to be the case. Nonetheless, even if this were the case, this study’s results and main conclusions would remain unaffected since this means we would end up with the total population of high-profile cases, which are the most interesting cases to consider since we are explicitly investigating egregious separation payments. Also, in terms of generalizability, beyond the sample question, our study focuses on a single country, Italy. This institutional context is particularly suitable for our study purposes, as we noted, and having one context helps reduce any confounding effects of heterogeneity due to different institutional settings. However, a multi-country analysis could contribute to and refine our results by enlarging the spectra of soft and hard laws that define corporate governance. On that note, additional research might include other internal corporate governance quality indicators.

One of the most interesting research avenues we offer is not only the empirical study of actual payouts (versus ex-ante agreements) but their theoretical underpinnings. Indeed, existing theoretical justifications refer to the ex-ante agreements rather than the actual payouts, yet they

differ substantially (Goldman and Huang, 2015, Klein *et al.*, 2017, Yermack, 2006). For example, arguing that separation payments function as market mechanisms to compensate executives for undervalued human capital (ex-post settling up theory) or their commitment to shareholder interests (bonding theory) does not make much sense when considering actual payouts. Damage control theory (Yermack, 2006) appears to be the most straightforward application, but other theoretical underpinnings of ex-post separation payments might exist. Moreover, continued research should test their alignment with shareholders' interests and more broadly with stakeholders' interests (Cuomo *et al.*, 2015, Evans and Hefner, 2009). Finally, we have not delved into payment structures. Yermack (2006) argues that categories of discretionary separation pay include: lump-sum payments, consulting, and non-compete agreements, pension augmentations, and adjustments to equity compensation. A recent theoretical paper proposes that separation payments could be structured to be more effective "in generating value for executives and shareholders" (Cowen *et al.*, 2016). Although the prediction refers to ex-ante agreements, it might be relevant for ex-post separation payments too.

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Table 1
Variable descriptions

Variable	Description	Source
<i>Dependent variables</i>		
LnSepPay	Natural logarithm of the ratio of the total separation payment amount received by the executive who left the firm to the number of years spent working in the firm.	Pay Watch (II Sole 24 Ore); Annual remuneration report of the fiscal separation year
LnCompRat	Natural logarithm of the ratio of total separation payment to the non-variable component of the annual compensation.	Pay Watch (II Sole 24 Ore); Annual remuneration report of the fiscal separation year
<i>Explanatory variables</i>		
Duality	A dummy variable indicating if the CEO also chairs the board.	Annual CG report and/or annual financial statement of the fiscal separation year
MultDir	A dummy variable indicating if the executive serves on multiple boards.	Annual CG report of the fiscal separation year
CompComm	A dummy variable indicating if the firm has a compensation committee.	Annual CG report of the fiscal separation year
Clawback	A dummy variable indicating if a clawback provision is included in the ex-ante contractual agreements between the executive and the firm.	Annual remuneration report of the fiscal separation year
FamFirm	A dummy variable indicating if the majority shareholder is a family.	Annual CG report of the fiscal separation year and/or Consob website
StateFirm	A dummy variable indicating if the majority shareholder is the state.	Annual CG report of the fiscal separation year and/or Consob website
InstInv	A dummy variable indicating if institutional investors are present among the firm shareholders.	Annual CG report of the fiscal separation year and/or Consob website
Post2011	A dummy variable indicating if the executive left the post after 2011.	Pay Watch (II Sole 24 Ore)
<i>Control variables</i>		
ManDir	A dummy variable indicating if the person leaving the post is the managing director.	Pay Watch (II Sole 24 Ore); Annual remuneration report of the fiscal separation year
LnBaseComp	Natural logarithm of the executive's base compensation in the year preceding the separation.	Annual remuneration report of the fiscal year before a manager leaves the post
Tenure	Length of the executive's tenure in the firm in years.	Pay Watch (II Sole 24 Ore)
LnAge	Natural logarithm of the executive's age.	Executive's CVs
Growth	Market-to-book ratio.	Eikon (Thomson Reuters) -- The fiscal year before a manager leaves the post

Lev	Ratio of long-term debts to total assets.	Eikon (Thomson Reuters) -- The fiscal year before a manager leaves the post
LnSize	Natural logarithm of the firm market capitalization.	Eikon (Thomson Reuters) -- The fiscal year before a manager leaves the post.
SpecRisk	Specific risk measure, calculated following Anderson and Fraser (2000) and Demsetz and Strahan (1997). We regress the returns of each firm on the market index returns. Then, we use the results of the regression to divide the total variance of the returns into an explained systematic part and an unexplained specific part.	Eikon (Thomson Reuters)
SystRisk	Systematic risk measure, calculated following Anderson and Fraser (2000) and Demsetz and Strahan (1997). We regress the returns of each firm on the market index returns. Then, we use the results of the regression to divide the total variance of the returns into an explained systematic part and an unexplained specific part.	Eikon (Thomson Reuters)
Financial	A dummy variable indicating if the firm is a financial institution.	Eikon (Thomson Reuters)
Crisis	A dummy variable indicating if the executive left the post in the period from 2007 to 2009.	-

Table 2**Descriptive statistics**

This table shows descriptive statistics for all the variables described in the Measures section, including means, standard deviations (SD), medians, minima (Min), and maxima (Max). The total number of observations is 74.

Variable	Mean	SD	Median	Min	Max
<i>Dependent variables</i>					
SepPay (mln €)	1.37	1.69	0.89	0.02	8.60
CompRat (no log)	14.50	27.02	4.56	0.44	163.16
<i>Explanatory variables</i>					
Duality	0.06	0.25	0	0	1
MultDir	0.47	0.50	0	0	1
CompComm	0.79	0.41	1	0	1
Clawback	0.12	0.32	0	0	1
FamFirm	0.26	0.44	0	0	1
StateFirm	0.16	0.37	0	0	1
InstInv	0.87	0.34	1	0	1
Post2011	0.22	0.42	0	0	1
<i>Control variables</i>					
ManDir	0.44	0.50	0	0	1
BaseComp (mln €)	0.99	0.89	0.79	0.00	4.02
Tenure	7.16	4.69	6.00	1.00	21.00
Age (no log)	59.55	9.76	59.00	43.00	84.00
Growth	1.45	0.89	1.34	0.20	3.83
Lev	0.51	0.27	0.54	0.00	0.97
Size (mln €)	19338.18	11972.70	17456.88	2542.23	52461.20
SpecRisk	0.26	0.09	0.24	0.13	0.53
SystRisk	0.22	0.12	0.22	0.03	0.59
Financial	0.43	0.50	0	0	1
Crisis	0.32	0.47	0	0	1

Table 3
Correlation matrix

This table shows the correlation matrix for all variables used in the empirical analysis.

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	
LnSepPay (1)	1																					
LnComRat (2)	0.58*	1																				
Duality (3)	-0.10	-0.06	1																			
MultDir (4)	0.09	0.19	-0.25*	1																		
CompComm (5)	-0.02	-0.06	0.14	0.03	1																	
Clawback (6)	-0.07	-0.26*	-0.10	-0.10	-0.11	1																
FamFirm (7)	0.12	0.26*	-0.16	0.10	0.23*	-0.22	1															
StateFirm (8)	-0.36*	-0.08	0.61*	-0.12	0.13	-0.04	-0.25*	1														
InstInv (9)	0.25*	0.03	-0.21	0.13	-0.10	0.02	0.05	-0.47*	1													
Post2011 (10)	-0.08	-0.23	-0.14	-0.37*	0.12	0.39*	-0.10	-0.14	0.11	1												
ManDir (11)	0.11	0.03	-0.02	-0.10	0.13	0.16	-0.05	-0.09	0.03	0.22	1											
LnBaseComp (12)	-0.08	-0.68*	-0.21	-0.10	-0.15	0.06	-0.25*	-0.09	0.13	0.14	-0.31*	1										
Tenure (13)	-0.52*	-0.17	0.05	0.07	-0.07	0.03	0.13	0.09	-0.03	0.00	-0.25*	0.24*	1									
LnAge (14)	-0.22	-0.38*	0.19	0.11	0.01	-0.08	-0.12	0.24*	-0.10	-0.20	-0.30*	0.35*	0.22	1								
Growth (15)	-0.03	0.04	0.07	0.06	-0.02	-0.09	-0.04	0.19	-0.27*	-0.27*	-0.28*	0.02	0.04	0.10	1							
Lev (16)	0.15	-0.03	-0.20	0.06	-0.17	0.11	-0.16	-0.32*	0.28*	0.14	0.13	0.09	-0.19	-0.18	-0.66*	1						
LnSize (17)	0.12	-0.02	0.12	0.07	-0.19	-0.07	-0.32*	0.33*	-0.07	-0.26*	-0.11	0.11	-0.11	0.25*	0.30*	0.02	1					
SpecRisk (18)	0.05	0.16	0.06	-0.18	0.18	0.05	0.14	-0.15	0.02	0.19	0.08	-0.18	-0.12	-0.27*	-0.46*	0.30*	-0.62*	1				
SystRisk (19)	-0.05	0.07	-0.08	-0.12	0.04	0.26*	0.03	-0.19	0.18	0.34*	0.12	-0.06	0.02	-0.20	-0.62*	0.48*	-0.29*	0.66*	1			
Financial (20)	0.09	0.01	-0.23*	0.08	-0.40*	0.34*	-0.15	-0.3721*	0.26*	0.11	-0.03	0.13	-0.02	-0.05	-0.42*	0.60*	-0.06	0.26*	0.55*	1		
Crisis (21)	0.04	0.06	-0.18	0.24*	-0.06	-0.25*	0.10	-0.22	0.19	-0.37*	-0.17	-0.24*	-0.12	-0.09	0.09	-0.11	-0.17	-0.08	-0.24*	-0.04	1	

Significance codes: * p<0.10, ** p<0.05, *** p<0.01.

Table 4

Regression models to test H1 (a-d) and H2 (a-c)

This table contains the estimation results for linear models, obtained with ordinary least squares. In Models 1 and 2, the dependent variable is the natural logarithm of the total separation payment. In Models 3 and 4, it is the natural logarithm of the compensation ratio. Models 1 and 3 are full models, including all explanatory and control variables. Models 2 and 4 are restricted models, chosen according to a general-to-specific stepwise approach. The number of observations is 74. * $p < .10$, ** $p < .05$, *** $p < .01$. Robust firm-clustered standard errors are in brackets.

Variable	Expected Sign	1 separation payment (log)	2 separation payment (log)	3 comp. ratio (log)	4 comp. ratio (log)
Constant		12.39*** [4.39]	8.22** [3.56]	12.73** [4.88]	18.00*** [3.55]
Duality	H1a: +	1.11* [0.55]	0.84* [0.47]	1.03 [0.73]	1.16* [0.63]
MultiDir	H1b: +	0.48** [0.20]	0.40** [0.18]	0.79** [0.32]	0.80** [0.31]
CompComm	H1c: -	0.09 [0.27]	0.08 [0.23]	-0.64* [0.34]	-0.71** [0.28]
Clawback	H1d: -	0.13 [0.39]	0.12 [0.31]	-0.95 [0.63]	-0.96 [0.57]
FamFirm	H2a: +	0.40* [0.21]	0.36* [0.19]	0.93*** [0.32]	0.82** [0.34]
StateFirm	H2b: -	-1.72*** [0.51]	-1.71*** [0.50]	0.03 [0.63]	0.13 [0.52]
InstInv	H2c: -	0.27 [0.56]	0.37 [0.53]	-0.23 [0.52]	-0.27 [0.49]
ManDir		-0.05 [0.30]		0.32 [0.33]	
LnBaseComp		0.03 [0.03]			
Tenure		-0.12*** [0.04]	-0.12*** [0.03]	-0.05 [0.04]	-0.07** [0.03]
LnAge		-1.19 [0.85]		-3.75*** [1.06]	-3.82*** [0.86]
Growth		-0.32* [0.17]	-0.25 [0.16]	-0.02 [0.29]	
Lev		-1.36*** [0.49]	-1.09** [0.45]	-1.68** [0.80]	-1.29** [0.59]
LnSize		0.71** [0.29]	0.65** [0.29]	0.44 [0.38]	
SpecRisk		4.04* [2.04]	4.11* [2.12]	3.28 [2.36]	
SystRisk		-2.55 [1.64]	-2.54* [1.39]	2.02 [2.89]	3.36 [2.20]
Financial		0.02 [0.31]		0.21 [0.39]	
Crisis		-0.47* [0.26]	-0.52** [0.20]	0.12 [0.39]	
F-test		14.40***	8.54***	8.78***	5.09***
adjusted R ²		0.42	0.43	0.24	0.30

Table 5

Regression models with interactions to test H3

This table contains the estimation results for linear models, obtained with ordinary least squares. In Model 1, the dependent variable is the natural logarithm of the total separation payment. In Model 2, it is the natural logarithm of the compensation ratio. The models include all explanatory variables and a subgroup of control variables chosen according to a general-to-specific stepwise approach. The number of observations is 74. * $p < .10$, ** $p < .05$, *** $p < .01$. Robust firm-clustered standard errors are in brackets.

Variable	expected sign	1 separation payment (log)	2 comp. ratio (log)
Constant		10.47** [5.05]	18.64*** [3.55]
Duality		1.39** [0.64]	0.92 [0.63]
MultiDir		0.41 [0.26]	0.49 [0.40]
CompComm		-0.1 [0.28]	-0.6 [0.39]
Clawback		0.72 [0.87]	-0.92 [1.03]
FamFirm		0.57*** [0.20]	0.80** [0.34]
StateFirm		-1.78*** [0.57]	0.08 [0.49]
InstInv		0.18 [0.64]	-0.2 [0.49]
Post2011		-1.87** [0.70]	-2.48*** [0.74]
Post2011XMultiDir	H3: +	1.83*** [0.59]	2.68*** [0.36]
Post2011XCompComm	H3: +	2.13*** [0.60]	1.82** [0.68]
Post2011XClawback	H3: +	-0.7 [1.07]	0.44 [0.96]
LnBaseComp		0.06** [0.02]	
Tenure		-0.10*** [0.03]	-0.06* [0.03]
LnAge		-1.58** [0.66]	-3.96*** [0.84]
Growth		-0.35** [0.16]	
Lev		-1.60*** [0.56]	-1.25** [0.60]
LnSize (log)		1.02*** [0.30]	
SpecRisk		4.69* [2.50]	
SystRisk		-2.39 [1.65]	3.59 [2.26]
F-test		4.34***	2.89***
adjusted R ²		0.47	0.31

Table 6
Regression models to test H4

This table contains the estimation results for linear models, obtained with ordinary least squares. In Model 1, the dependent variable is the natural logarithm of the total separation payment; and in Model 2, it is the natural logarithm of the compensation ratio. The models include all explanatory variables and a subgroup of control variables chosen according to a general-to-specific stepwise approach. The number of observations is 74. * $p < .10$, ** $p < .05$, *** $p < .01$. Robust firm-clustered standard errors are in brackets.

Variable	expected sign	1 separation payment (log)	2 comp. ratio (log)
Constant		13.07*** [4.07]	13.87*** [4.79]
Post2011		0.37 [0.44]	-0.01 [0.44]
Financial		0.29 [0.25]	0.67* [0.38]
Post2011XFinancial	H4: -	-0.81* [0.45]	-1.46** [0.69]
Duality		1.07** [0.48]	0.76 [0.51]
MultiDir		0.47** [0.19]	0.60* [0.30]
FamFirm		0.32* [0.18]	0.90*** [0.25]
StateFirm		-1.82*** [0.43]	
ManDir			0.41 [0.27]
Tenure		-0.12*** [0.03]	
LnAge		-1.18 [0.70]	-4.54*** [1.03]
Growth		-0.31* [0.17]	
Lev		-1.25** [0.46]	-1.33** [0.56]
LnSize		0.70** [0.30]	0.53* [0.29]
SpecRisk		3.88* [2.29]	4.54** [1.91]
SystRisk		-2.8 [1.76]	
Crisis		-0.53** [0.23]	
F-test		11.26***	5.81***
adjusted R ²		0.45	0.32

Figure 1

Binding vs. advisory corporate governance practices

This plot shows the separation payments and compensation ratios of financial and non-financial firms before and after 2011. The plot is based on the results in Table 6.

