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Employee rights and acquisitions ☆

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ABSTRACT

This paper examines the outcomes and characteristics of corporate acquisitions from the perspective of stakeholder-shareholder agency conflicts. Using state variation in labor protections, we find that acquirers with strong labor rights experience lower announcement returns. Combined acquirer and target announcement returns are also lower in the presence of strong labor rights. Our findings remain statistically and economically significant after we control for a range of deal, firm, industry and state characteristics and explore various channels for the labor rights effect. Overall, the evidence indicates that employee-shareholder conflicts of interest reduce shareholder gains from acquisitions.

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1. Introduction

A large corporate finance literature dating back to Jensen and Meckling (1976) has focused on manager-shareholder and shareholder-bondholder agency conflicts. Potential agency conflicts involving employees and their impact on firm investment decisions have received far less attention in existing work. Acquisitions represent a crucial value-relevant investment decision, especially for mature firms. While other work has looked at how managerial agency conflicts affect merger and acquisition outcomes, this paper focuses on the understudied question of the role of shareholder-employee conflicts of interest in the context of acquisitions. We exploit variation in employee protections to quantify the effects of employees on the shareholder value implications of acquisitions.

Conceptually, shareholders and employees have different objective functions. Shareholders are focused on equity value. Employees seek to maximize their utility, which reflects compensation, private benefits, job security and leisure (reduced effort). Some acquisitions that generate value for shareholders can reduce employee utility in the process of restructuring. For example, achieving synergies and productivity gains from an acquisition can involve layoffs, decreases in compensation or benefits, or increases in required employee effort.

We argue that conflicts of interest due to different objective functions of shareholders and employees have a

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larger impact on shareholder value in the presence of strong labor protections. Employees in strong labor rights states have more bargaining power, backed by an implicit threat of collective action, particularly when organized labor is involved. Strong labor protections give employees as a group more power to bargain regarding the selection of targets and negotiation of deal terms and to thwart a labor-unfriendly deal. After the acquisition, labor protections can constrain firms from certain restructuring decisions aimed at realizing synergies. Labor protections also influence employee incentives to exert privately costly effort, which can affect productivity gains realized during the integration process. Overall, employee-shareholder conflicts of interest are expected to reduce shareholder gains from M&As.

Empirically, acquirers in strong labor rights states generate less shareholder value through acquisitions. Five-day cumulative abnormal returns (CARs) on acquisition announcement are on average 0.5% lower for strong labor rights acquirers compared with weak labor rights acquirers, all else equal. The differential is highly statistically and economically significant and robust to controlling for various firm and deal characteristics, state business environment, and industry factors as well as a number of other sensitivity tests. Consistent with our hypothesis, the effect of labor rights on acquisition returns is largest in labor-intensive industries and in industries with a higher prevalence of collective bargaining. We find that labor rights affect the selection of target and deal characteristics. For instance, strong labor rights acquirers are more likely to bid for strong labor rights and high labor cost targets and to engage in risk-reducing acquisitions. In addition to selecting better deals, weak labor rights acquirers are on the margin more likely to undertake large workforce reductions and realize significant gains in profitability per employee after the acquisition, which is reflected in better announcement returns. Finally, the labor rights effect is not a zero-sum game between target and acquirer shareholders. Combined announcement returns, which capture the market's expectation of overall synergies created for shareholders of the two firms, are significantly lower for bids involving strong labor rights acquirers. After controlling for the employee-shareholder conflicts of interest within the acquirer firm, the target's labor rights regime does not have incremental significance, which is not surprising in light of the much smaller average target size. Overall, the evidence supports the negative shareholder value effects of agency conflicts involving shareholders and employees in the context of mergers and acquisitions.

The paper is organized as follows. Section 2 discusses hypotheses and related work. Section 3 describes data and variables. Section 4 presents results. Section 5 concludes.

2. Hypotheses and related work

Acquisitions involve large projects with significant firm value effects and offer an intuitive setting for studying conflicts of interest. Due to incomplete contracting, shareholders cannot fully observe and verify projected synergies or prevent suboptimal deals from occurring. The impact of managerial agency conflicts on acquisitions has been actively studied [see, e.g., Lang, Stulz, and Walkling 1991; Servaes, 1991; Masulis, Wang, and Xie, 2007; also see Betton, Eckbo, and Thorburn, 2008 for a review of prior work]. By contrast, the employee-shareholder incentive conflict has not received much attention in the M&A context. Our paper provides new evidence on the effects of employee rights and employee-shareholder incentive conflicts on M&A outcomes and shareholder wealth implications.

2.1. Related work

Finance research into the effects of employees on firms is relatively scarce. Chen, Kacperczyk, and Ortiz-Molina (2011) show that higher returns compensate for the decrease in operating flexibility due to the presence of a union. Addessi and Busato (2009) predict a positive effect of unions on volatility and the equity risk premium. Hilary (2006) argues that management facing strong organized labor seeks to preserve information asymmetries to retain an advantage in collective bargaining, resulting in higher bid-ask spreads, lower trading volume, lower analyst following, and a higher probability of informed trading. Several studies have focused on capital structure implications. Matsa (2010) finds that strong labor rights cause firms to choose high leverage to disgorge free cash flow and strengthen their bargaining position. Myers and Saretto (2011) show that strikes are less likely at highly leveraged firms, so firms vulnerable to strikes increase leverage. Simintzi, Vig, and Volpin (2015) find in a cross-country setting that firms reduce leverage in response to increased employee power. Chen, Kacperczyk, and Ortiz-Molina (2012) find that firms with strong unions take less risk and face a lower cost of debt. Bauer, Derwall, and Hann (2009) show that employee-friendly firms, defined using KLD Research & Analytics, Inc. data, take less risk, attain better debt ratings, and face lower bond spreads. Agrawal and Matsa (2013) find that companies in states with low unemployment benefits choose lower leverage and more conservative financial policies to mitigate risk to employees. Focusing on firm value, Agrawal (2012) shows that votes by funds backed by the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) have a negative effect on firm value. Kim and Ouimet (2014) examine broad-based employee stock ownership plans (ESOPs) and find mixed effects on firm value and wages depending on plan size. Some studies find better performance and productivity at labor-friendly firms.[1]

[1] See, e.g., Edmans, 2011; Filbeck and Preece, 2003; Faleye and Trahan, 2011. Ouimet and Zarutskie (2011) find partial pass-through of merger gains to employees in the form of higher wages. Chang, Kang, and Zhang (2012) argue that underfunded pension plans strengthen employee oversight of the management, resulting in fewer M&As and higher returns, especially for plans with more active participants and collective bargaining. As post-acquisition restructuring is likely to transfer wealth from employees to shareholders, this argument is less likely to apply to our analysis. The exception would be a scenario in which shareholder synergies are due to sources that can benefit employees as well as shareholders (such as increased market power with consumers or suppliers, new technologies or optimization of operating costs unrelated to labor). We are able to distinguish our main hypothesis from this competing possibility based on the sign of the labor rights effect on shareholder returns.