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CEO deal-making activities and compensation ☆

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ABSTRACT

Using transactions generally overlooked in the compensation literature—joint ventures, strategic alliances, seasoned equity offerings (SEOs), and spin-offs—we find that, beyond compensation for increases in firm size or complexity, chief executive officers (CEOs) are rewarded for their deal-making activities. Boards pay CEOs for the core motivation of the deal, as well as for deal volume. We find that compensating for volume instead of core value creation occurs under weak board monitoring and that in deal-making firms, neither CEO turnover nor pay-for-performance responds to underperformance. We introduce an input monitoring explanation for these results: boards compensate for deal volume because of their inability to perfectly monitor outputs.

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1. Introduction

Absent moral hazard problems of the types described by Hölmstrom (1979) and others, chief executive officers (CEOs) should only implement deals that enhance their firms' values, which implies that deals are a logical assessment tool for boards' compensation decisions. However, in the presence of moral hazard, boards need to consider whether this assessment tool reflects suitable incentives for CEOs to choose activities that increase shareholder wealth.

Important evidence exists on this issue as previous research (e.g., Harford and Li, 2007; Grinstein and Hribar, 2004; Bliss and Rosen, 2001) shows that acquiring CEOs are rewarded for mergers, even if the transactions are not successful. Yet, it is unclear whether acquiring CEOs are being paid for the deal itself or for possible by-products of the acquisition such as increases in firm size or complexity. We address this question by examining other types of deal-making activity [e.g., joint ventures, strategic alliances, seasoned equity offerings (SEOs), and spin-off deals] that are not generally subject to changing size and complexity. In particular, we study the specific motivations for executing those deals and their relation to market expectations and CEO compensation.

We first evaluate whether boards of directors appear to consider deal activity when structuring their CEOs' pay. Using compensation committee reports from 400 randomly selected deal-making firms and 400 randomly selected non-deal-making firms, we tally reasons the committees give for their decisions. Consistent with previous research (Bizjak, Lemmon, and Naveen, 2008; Bizjak, Lemmon, and Nguyen, 2011; Faulkender and Yang, 2010), we find that across all firms in the random samples the two most common types of explanations involve firm performance and benchmarking the CEO's compensation to peer firms' compensation. However, by separating the explanations between deal-making and non-deal-making firms, we find striking differences. For example, performance-based justifications are mentioned significantly less often in the reports of deal-making firms. Instead, the boards of these companies cite their CEOs' deal-making activities or leadership skills to explain their compensation decisions, implying that CEOs are rewarded, at least in part, on the basis of entering deals. These results suggest that deal making itself is an important component of the board's compensation decision.

Using different multivariate specifications in a large sample of 11,815 firm-year observations, we find that changes in CEO compensation are significantly related to the CEOs' deal-making activities. In fact, a CEO who initiates a joint venture, strategic alliance, SEO, or spin-off receives an additional $400,000 in total compensation, on average. One possible explanation for these results is that deal-making CEOs are systematically different from CEOs not undertaking such activities. To consider this alternative explanation for our results, we conduct a matched-firm difference-in-differences (diff-in-diff) analysis that accounts for systematic variations between deal-making and non-deal-making firms and is robust to controls for merger activity and other determinants of CEO compensation (such as changes in firm size and complexity). Consistent with our initial findings, this analysis indicates that greater CEO pay changes are associated with specific deals, thus supporting the hypothesis that boards consider CEO deal-making in their compensation decisions.

We next consider whether the pay raises to deal-making CEOs are linked to firm performance. Pay-for-performance sensitivity (PPS) analyses show that compensation for deal-making CEOs is markedly sensitive to good performance but apparently insensitive to bad performance. This analysis suggests that deal-making activities insulate CEOs from poor performance and that CEO wealth can increase even under apparent poor deal decisions.

These results are puzzling in that CEOs appear to be rewarded for deals regardless of performance. One potential explanation for these findings derives from economic theory that proposes an alternative method to provide incentives to agents such as firm managers–monitoring their observable inputs. Specifically, Khalil and Lawarrée (1995) and Raith (2008) theorize that principals (such as boards of directors) can base the compensation of agents (such as CEOs) on input or output monitoring. Their theories posit that, while monitoring observable outputs (such as firm performance) is the dominant strategy to incentivize agents, it could be optimal in some situations to consider observable inputs to the agents' tasks (e.g., Lazear and Rosen, 1981; Lazear, 2000; Raith, 2008; Zhao, 2008). For example, Raith (2008) argues that a combination of input and output monitoring can result in optimal incentives, particularly in cases in which the output measure is not perfectly observable, is noisy, or is confounded by other events.[4] However, Lazear and Rosen note that basing compensation on inputs with less than perfect monitoring could invite moral hazard. Similarly, Zhao's model implies that when the principal must rely on inputs as a proxy for an agent's efforts, moral hazard could arise if the agent directs attention toward the satisfaction of the input measure instead of toward the task's success. Basing empirical tests on this premise, we examine whether CEO incentives to enter into deals could develop because the deal-making activity itself changes their risk of termination. We find this to be the case in that deal making appears to curtail the inverse firm performance-CEO turnover relation shown in earlier studies (e.g., Weisbach, 1988; Parrino, 1997a). Thus, deal making can insulate CEOs from the risk of being fired for poor performance.

We next examine each of our specific deal types following the academic literature for the type of deal (i.e., joint ventures, strategic alliances, SEOs, and spin-offs). We test whether specific deal features are more likely to elicit a pay increase. That is, we consider the motivation for the deal. Because our tests indicate that deal making can insulate CEO pay from poor performance as well as insulate some poorly performing CEOs from losing their jobs, we evaluate whether the motivation for each deal type is more consistent with this insulating motivation, which would be empire building, or whether the motivation for the deal

[4] The results from our compensation committee reports analyses also suggest that input monitoring is an important component of the board's compensation decision, consistent with the theoretical arguments in Khalil and Lawarrée (1995) and Raith (2008).

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