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CEO network centrality and merger performance ☆

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ABSTRACT

We study the effects on M&A outcomes of CEO network centrality, which measures the extent and strength of a CEO's personal connections. High network centrality can allow CEOs to efficiently gather and control private information, facilitating value-creating acquisition decisions. We show, however, that M&A deals initiated by high-centrality CEOs, in addition to being more frequent, carry greater value losses to both the acquirer and the combined entity than deals initiated by low-centrality CEOs. We also document that high-centrality CEOs are capable of avoiding the discipline of the markets for corporate control and the executive labor market, and that the mitigating effect of internal governance on CEO actions is limited. Our evidence suggests that corporate decisions can be influenced by a CEO's position in the social hierarchy, with high-centrality CEOs using their power and influence to increase entrenchment and reap private benefits.

1. Introduction

Recent advances in finance research have documented significant financial consequences when there are personal connections among firm executives, board members, bankers, and other financial market participants. Formed through common education, work experience, or interconnecting board seats, these connections can facilitate certain value-creating financial transactions while altering behavior and even destroying value in other settings.

Personal connections provide an effective channel for information exchange, allowing transmission of knowledge, ideas, or private information. In the context of bank loan negotiations, Engelberg, Gao, and Parsons (2012) show that informal ties between a borrower and a lender result in larger loan amounts, lower interest rates, and less restrictive covenants. Cohen, Malloy, and Frazzini (2010) find that sell-side analysts perform better if they share an alma mater with key executives of covered firms. Larcker, So, and Wang (2013) show that firms with central boards earn superior risk-adjusted stock returns that can be attributed to greater information access.

On the other hand, pre-existing personal ties appear to interfere with effective corporate governance and director monitoring by weakening independent judgment and

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subverting rational decision-making, resulting in suboptimal behavior and inferior economic outcomes. Fracassi and Tate (2012) show that CEO–director connections weaken board monitoring and destroy corporate value. Hwang and Kim (2009) find that firms with board members who are personally connected to the CEO have higher CEO compensation, lower pay-performance sensitivity, and lower turnover-performance sensitivity. Chidambaran, Kedia, and Prabhala (2012) show that the likelihood of fraud is higher in the presence of CEO–director connections that are formed outside the professional sphere.[1]

What remains puzzling is the order of the social hierarchy, or the direction of command and control. Social connections are mutual: person A knowing person B is equivalent to person B knowing person A. But a willingness to share valuable, private information in order to benefit others, thereby risking breaking the law and potentially getting caught, fined, or sanctioned, is difficult to explain. Why do directors display loyalty to a CEO, even to the point of abandoning their own judgment and becoming submissive to the CEO's demands, but not the other way around? Focusing on pairwise connections cannot give satisfactory answers.

In this paper, we assert that positions in a social network are unequal and that there exists a hierarchical order in social relations. Individuals residing higher in a hierarchy possess more information, greater resources, and thus more power in exercising their decision rights. CEOs with such advantageous positions can use their social status to influence corporate policies and dictate board decisions. On the other hand, these individuals might also come to believe in their own infallibility, which can lead to value destruction (e.g., Malmendier and Tate, 2008, 2009; Fogel, Ma, and Morck, 2014).

Following a long history of studies in graph theory (e.g., Proctor and Loomis, 1951; Sabidussi, 1966; Freeman, 1977; Bonacich, 1972), we argue that network centrality, which is a collection of measures that describe an individual's position in a social network, can capture a CEO's ability to access information, command others, and influence economic decision-making (Padgett and Ansell, 1993; Hanneman and Riddle, 2005; Banerjee, Chandrasekhar, Duflo, and Jackson, 2012; Jackson, 2010). We calculate CEO network centrality measures and evaluate the effect of CEO network centrality on merger and acquisition outcomes. Mergers and acquisitions provide fertile ground to test the impact of CEO network centrality because success, particularly on the bidder side, depends not only on a CEO's knowledge of the target and its future prospects but also on the CEO's ability to convince the board and close the deal. Well-networked CEOs could be in a better position to obtain low-cost private information (Burt, 1997; Nahapiet and Ghoshal, 1998) from their network contacts to aid in bidding and negotiation. On the other hand, these CEOs might use the power achieved through their network influence (Mizruchi and Potts, 1998) to secure board support and push for deal completion, regardless of the impact on shareholders (Bebchuk, Cremers, and Peyer, 2011; Masulis, Wang, and Xie, 2007).[2]

Our paper is particularly timely because previous studies of social connections in M&A reach different conclusions. Cai and Sevilir (2012) find lower takeover premiums when the acquirer and the target share a common director, and greater value creation for the acquirer when one acquirer director and one target director serve on the same third board. On the other hand, Ishii and Xuan (2014) argue that acquirer–target social ties lead to poorer decision-making and value destruction: connected deals are more likely to occur, deals are more likely to be subsequently divested due to poor performance, bidder CEOs are more likely to receive bonuses and higher compensation for completing mergers, and there is a significant value loss for shareholders of both the acquirer and the combined entity. We argue that a CEO's position in the social network is at least as important as the connection to a particular transacting partner, and that focusing only on bilateral, non-directional ties can yield inconclusive results.

We use BoardEx data to construct a social network of CEOs of U.S. firms and calculate *closeness*, *degree*, *betweenness*, and *eigenvector* centrality measures for all individuals connected in this vast network. Our results show that higher-centrality acquirer CEOs are associated with more frequent acquisitions of U.S. public targets by S&P 1500 companies over the period January 2000–December 2009. Increasing CEO centrality from the 25th to the 75th percentile of the sample increases the relative frequency of acquisitions by 28.0%, on average. In addition, abnormal returns to bidder shareholders, as well as total takeover synergies (measured by the weighted average of bidder and target abnormal shareholder returns), are negative in deals initiated by bidder CEOs with above-median network centrality. Increasing CEO centrality from the 25th to 75th percentile of the sample decreases acquirer CARs by 3.42 percentage points and total synergies by 3.06 percentage points, on average.

We then investigate whether internal and external corporate governance mechanisms can reduce the frequency of deals and prevent value destruction for firms with high-centrality CEOs. We find that factors generally associated with stricter internal governance, such as the intensity of board monitoring and the presence of large blockholders, mitigate high takeover frequency but have only limited ability to mitigate value-destructive M&A.[3]

We also find that the disciplining roles of both the external market for corporate control and the managerial

[1] Information transfer and monitoring impediment effects of social networks can jointly affect firm activities. For example, Duchin and Sosyura (2013) document both the positive and negative impacts of increased capital spending managers with social ties to the CEO.

[2] There are many reasons why bidder CEOs might benefit from value-destroying M&A deals. Due to the separation of ownership and control, CEOs are likely to accrue the full value of private benefits, while bearing only partial value of the losses associated with the acquisitions. The examples of private benefits include: higher post-merger managerial compensation due to the increase in firm's size (Jensen and Murphy, 1990), post-merger compensation packages insensitive to negative stock performance (Harford and Li, 2007) smoother post-merger earnings, leading to the lower likelihood of financial distress (Berger and Ofek, 1995), and increase in the cost of CEO replacement if acquisitions involve manager-specific investments (Shleifer and Vishny, 1989).

[3] Intense monitoring boards are defined as those where majority of independent board members have two or more membership in auditing, compensation, and nomination committees (Faleye, Hoitash, and Hoitash, 2011).