



## Do target CEOs trade premiums for personal benefits?



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### ABSTRACT

Using a sample of 2198 completed M&A transactions between 1994 and 2010 in which both target and acquirer are public US firms supplemented with hand-collected data for target CEO retention, we uncover a significantly negative relation between target CEO retention and takeover premiums received by target shareholders. Further, when the target CEO was not retained, we document a significantly negative relation between the relative importance of the severance pay received by the target CEO and takeover premium. Taken together, our findings, which hold in various robustness tests, suggest that target CEOs bargain shareholder value for personal benefits during corporate takeovers. Our findings have important policy implications for takeover disclosures.

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### 1. Introduction

The performance of mergers and acquisitions (M&A) hinges not only on macro and micro economic factors like economic cycles, merger waves, and the potential synergies between acquirers and targets, but also on such non-economic factors as the personal gains and losses of target and acquirer management teams. The literature suggests that the compensation and benefits of acquirer CEOs affect M&A outcomes.<sup>1</sup> On the target side, [Song and Walkling \(1993\)](#) and [Stulz et al. \(1990\)](#) document a positive relation between target CEO stock ownership and target stock returns, and [Heitzman \(2006\)](#) finds equity grants to target CEOs to be positively associated with target shareholder value. But evidence that target CEOs bargain shareholder value for personal benefit is limited in the extant literature (discussed in detail below).

Since [Berle and Means \(1932\)](#), many studies have posited that when the separation of ownership and control in modern corporations gives rise to conflicts of interest between managers and

shareholders, self-interested managers will take actions that benefit them at the expense of, and that result in substantial agency costs to, shareholders. This proposition is termed in the literature the conflict of interest, or agency, theory (see, for example, [Jensen and Meckling, 1976](#); [Jensen, 1986](#)). In the M&A setting, the consequences of transactions for target CEOs are potentially quite large. They may lose their job and power and their future income potential be significantly attenuated ([Hadlock et al., 1999](#)). In fact, target CEOs let go after their firms are acquired rarely find another executive position ([Agrawal and Walkling, 1994](#)). Expecting these potentially grave negative consequences, target CEOs may, during the takeover process, bargain not only over the premium to be paid to target shareholders, but also over personal items including position in the new (merged) firm, severance payments, and other last-minute personal benefits. Conflict of interest theory predicts that target CEOs, acting in their own self-interest, may bargain takeover premiums to be received by their shareholders for such personal benefits as an important position in the new firm, or, if asked to leave, additional cash severance payments. M&A deals and the benefits paid to target CEOs must, of course, be approved by corporate boards. But board decisions can often be influenced by target CEOs in self-interested ways ([Bebchuk and Fried, 2003](#); [Hermalin and Weisbach, 1998](#); [Jensen, 1993](#)).

Conflict of interest theory's reasoning for why target CEOs may bargain shareholder value for personal benefits may be compelling, but empirical evidence in the extant literature is limited and

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<sup>1</sup> For example, [Datta et al. \(2001\)](#) document a positive relation between acquirer managers' equity-based compensation and acquirer stock returns around and following acquisition announcements; they also find that acquirer managers with higher equity-based compensation pay lower takeover premiums. [Grinstein and Hribar \(2004\)](#) show that large bonuses awarded to acquirer CEOs are positively related to the completion of M&A deals and deal size, but not to deal performance.

inconclusive. For example, using a sample of 914 completed cash-only M&A transactions, [Bargeron et al. \(2010\)](#) find no evidence that target CEO retention (i.e., the CEO obtains a position in the new firm) is related to lower takeover premiums. [Bargeron et al. \(2013\)](#) further examine the role of private equity acquirers in the context of cash-only deals and find a positive relation between target CEO retention and takeover premiums for private equity acquirers. The authors interpret their evidence as supportive of private equity acquirers paying for valuable CEOs. [Hartzel et al. \(2004\)](#), using a sample of 311 completed M&A deals, find no evidence of target CEO retention or additional cash benefits *alone*, but some evidence of target CEOs' *combined* personal benefits, being related to a lower premium. By contrast, using a matched-sample approach with a sample of 40 friendly “mergers of equals” transactions (i.e., mergers of two firms close in size that result in roughly equal board representation in the new firm), [Wulf \(2004\)](#) finds the premium received by target shareholders to be lower when the target CEO is awarded an important seat on the new firm's management team, and [Fich et al. \(forthcoming\)](#), using a sample of 851 acquisition bids, find the importance of golden parachutes to target CEOs to be positively related to the likelihood of deal completion, but negatively related to the takeover premiums offered to target shareholders.

In this paper, employing a comprehensive sample of 2198 completed M&A transactions announced between 1994 and 2010 in which both target and acquirer are public US firms supplemented with hand-collected data on target CEO retention and severance payments received by non-retained CEOs, we uncover a significantly negative relation between target CEO retention and takeover premiums received by target shareholders. Retention of target CEOs is, on average, related to a 6-percentage-point reduction in 4-weeks takeover premium paid to target shareholders. Given the US\$ 1.15 billion average market capitalization of the target firms in our sample, this premium reduction translates into a sizable value loss of around US\$ 70 million to the shareholders of an average-size target. Moreover, when the target CEO was not retained, we document a significantly negative relation between the relative importance of severance pay received by target CEOs and the takeover premium received by target shareholders. Our investigation of the joint effect of target CEO retention and CEO severance pay on takeover premiums further confirms both effects to be significantly negative. Our main findings are robust to examining, instead of takeover premium, target cumulative abnormal stock returns around the deal announcement date.

A potential concern with our findings is that the results may be driven by endogeneity. Specifically, certain omitted variables may correlate with both target CEO retention and takeover premium, which could result in a spurious negative relation. A spurious relation may also be generated between severance pay and takeover premium by selection bias occasioned by the fact that only non-retained CEOs receive severance pay. We take several steps to address the endogeneity concern. First, controlling for a battery of CEO, target, deal, and acquirer characteristics commonly identified by the M&A literature as affecting takeover premium and announcement returns, as well as for industry and year fixed effects, we continue to find significantly negative effects of target CEO retention and severance pay on takeover premium and target announcement stock returns. Second, our findings continue to hold when we use [Demerjian et al.'s \(2012\)](#) managerial ability score as an instrument for predicting target CEO retention, and employ a Heckman two-stage correction approach. Third, we find the negative relation between target CEO retention and takeover premium to be strengthened when the target CEO obtained a more important position in the merged firm, and the negative relation between target CEO severance pay and takeover premium to be strengthened when severance pay is negotiated during the

takeover process rather than predefined in a CEO's golden parachute plan. Although none of these steps perfectly addresses endogeneity, all confirm our main conclusion. Taken together, these findings strongly suggest that target CEOs bargain shareholder value for personal benefits during corporate takeovers (which results in substantial agency costs to target shareholders), lending support to the conflict of interest, or agency, theory. The uncovered negative relation between target CEO retention and takeover premium, and between target CEO severance pay and premium, remain robust to controlling for target corporate governance strength and using alternative measures of CEO severance pay.

This paper makes two contributions to the literature. The first is that it uncovers a statistically significant and economically important negative relation between target CEO retention and takeover premium using a unique, comprehensive sample of M&A transactions by public US acquirers using all payment forms that differs substantially from the samples in [Bargeron et al. \(2010, 2013\)](#), which, being focused on private acquirer (especially private equity acquirer) deals, reflect exclusively cash-only transactions. As mentioned earlier, [Bargeron et al. \(2010, 2013\)](#) do not find a negative relation between target CEO retention and takeover premium. Specifically, based on the finding in [Bargeron et al. \(2008\)](#), that private equity acquirers pay significantly lower premiums than public acquirers, [Bargeron et al. \(2010, 2013\)](#) investigate whether target CEO retention explains this difference in premiums. In particular, [Bargeron et al. \(2010, 2013\)](#) consider two competing hypotheses: CEO conflict of interest vs. valuable CEO. [Bargeron et al. \(2010\)](#) find no evidence that target CEO retention is related to a lower premium. [Bargeron et al. \(2013\)](#) further find that private equity acquirers pay higher premiums, on average, when retaining target CEOs, which supports the valuable CEO hypothesis. They also find the probability of retention to be significantly higher for private equity acquirers, which, in concert with the valuable CEO hypothesis, suggests that private equity firms are more likely to need target CEOs to continue running the acquired assets than would public operating acquirers that have existing managers in place to run the acquired assets.

Since the evidence in [Bargeron et al. \(2010, 2013\)](#) suggests that private equity acquirers, but not public acquirers, pay more when retaining target CEOs (i.e., not likely the valuable CEO story for target CEO retention by public acquirers), the present paper investigates what, if not the valuable CEO hypothesis, motivates target CEO retention by public acquirers. Our evidence clearly supports the conflict of interest theory, and is consistent with the idea that retention by public operating acquirers that already have managers in place is likely motivated by target CEOs' willingness to bargain away shareholder value in exchange for keeping their jobs. The evidence suggests that agency issues are to blame for public acquirers paying lower premiums to target shareholders when the target CEO is retained.

Examining public acquirer transactions with all payment forms is important for at least three other reasons. First, most M&A transactions involving public US targets are conducted by public US acquirers (in the cash-only completed transaction sample of [Bargeron et al. \(2008\)](#), for example, only 27% of deals are conducted by private acquirers). Second, relative to private acquirers, public acquirers typically acquire much larger public target firms. In [Bargeron et al.'s \(2008\)](#) sample, for example, the average market capitalization of public target firms acquired by public acquirers is almost double that of those acquired by private acquirers. Acquirers are known, for reasons of better risk sharing, to be more likely to use equity to finance takeovers of larger targets ([Hansen, 1987](#)). Most completed M&A transactions conducted by public acquirers thus involve acquirer equity in payment consideration (e.g., in the SDC database, only around 26% of completed transactions by public US acquirers are cash-only). Third, CEOs of larger target

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