

# **FOR THE MANY OR THE FEW? EXTRAORDINARY BENEFITS RECEIVED BY TARGET CEOs DURING TAKEOVERS**

A COLLEGE SCHOLAR SENIOR THESIS PRESENTED IN PARTIAL FULFILLMENT  
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## **Abstract**

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Recent studies [Bebchuk and Fried (2002)] have shown that managerial power and negotiations play important roles in the design of executive pay arrangements, suggesting that some CEOs may extract greater economic rent from shareholders when provided with the opportunity. This paper seeks to explore CEOs rent-extracting behaviors by examining golden parachute lump sum payments received by target CEOs and other extraordinary gains they negotiated during M&As. These payments are significantly affected by the CEO's characteristics, firm size and whether the CEO is retained but appears to be unrelated to measures of performance. I find that retained CEOs are more likely to negotiate for additional gains but their success rates are dependent on the positions they occupy in the combined company. My analysis also provides evidence that all these extraordinary benefits (negotiated gains and post-acquisition positions) come at the expense of shareholders, highlighting an agency problem where CEOs trade shareholders value in return for their own personal benefits.

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## **Personal Background**

Wai Kin Wong received his education in Kuala Lumpur, Malaysia and subsequently Singapore, where he completed the GCE O-Levels and A-Levels before coming to Cornell University in 2007. He will be graduating after three and the half years in fall 2010, with dual degrees in B.Sc. Operations Research Engineering (ORIE) and B.A. Economics, College Scholar Program. Post-graduation, Wai Kin plans to travel the world before starting work in the Mergers and Acquisition division of Bank of America Merrill Lynch, New York.

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## 1. Introduction

Increasing CEO turnovers suggest the existence of a well-functioning labor market for senior executive talents where the compensation of the CEO can be determined by the market-clearing price he/she commands. However, in reality, it seems that these market rates are difficult to identify and instead depend much more on the negotiations between the CEO, his attorney, the compensation committee and the board of directors. Bebchuk, Fried and Walker (2002) have argued that when directors negotiate with executives, their proposals are constrained not so much by their belief of the market conditions as by the executives' bargaining power and negotiation tactics. Bebchuk and Fried (2003) also provide evidence that managerial power plays an important role in the design of executive pay arrangements and of corporate governance in general.

Negotiations of CEO's compensation clearly manifest themselves in common cases involving large lump-sum payments awarded to CEOs either when they are first brought in or before they leave the company. One example is the "golden parachute" payment guaranteed to the executive if the company is acquired by or merged into another company. The "golden parachute" has been argued to be a compensation mechanism that encourages the CEO to take riskier investments without fear that it would affect his employment [Narayanan and Sundaram (1998)]. This payment is often substantial and almost guaranteed unless the CEO is fired for cause. Because of its large size and lack of connection to performance, golden parachutes may create perverse incentives for the CEOs to make decisions that favor their own benefits at the expense of the shareholders. For example, overly attractive parachutes may incentivize CEOs to facilitate the sale of their companies at prices less favorable to their shareholders in order to obtain these rewards [Cotter and Zenner (1994)].

This rent extracting<sup>1</sup> behavior is further facilitated by the information asymmetry that exists between shareholders and top executives due to the lack of complete disclosures of what happens in the boardroom and also the ease of accounting manipulations. As shareholders often stand at the losing ends in these situations, golden parachutes as well as other awards representing extraordinary compensation for top executives ought to be a source of concern to shareholders.

To get an idea of the magnitude of these awards, table 1 presents some of the high-profile cases uncovered by the popular media. During the recent sub-prime mortgage crisis, while wealth that never existed was wiped out and thousands of jobs were lost, we read regular reports about hefty payouts being awarded to CEOs of large financial corporations, including those who supposedly contributed to the source of the financial meltdown. Some of these executives include Stanley O'Neal (Merrill Lynch), Charles Prince (Citigroup), Richard Syron (Freddie Mac), Daniel Mudd (Fannie Mae) and Martin Sullivan (AIG). What is more scandalous is how some of these CEOs who know that they will be departing, continue to blatantly extract benefits for themselves and other top executives while their companies face major financial losses. The former CEO of Merrill Lynch, John Thain, is a recent example<sup>2</sup>. Thain was reported to have accelerated \$4 billion in bonuses for Merrill's top executives just prior to the distressed sale of Merrill Lynch to Bank of America. On top of that, Thain proposed to the board a \$10 million bonus for himself for preventing Merrill from bankruptcy by engineering the sale of Merrill to Bank of

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<sup>1</sup> Rent extraction, academically, refers to the capturing of economic rent (difference between what a factor of production is paid and how it would need to be paid to remain in its current use) through manipulation or exploitation of the economic environment. In the case of my thesis, rent extraction refers to the extraction of uncompensated value from shareholders without any justification for productivity or performance. Source: *Pay without performance; The unfulfilled Promise of Executive Compensation*, Lucian Bebchuk and Jesse Fried 2006.

<sup>2</sup> See: "Thain Spars With Board Over Bonus at Merrill", *Wall Street Journal*, Dec 8, 2008; "Merrill Lynch CEO Thain spent \$1.22 million on Office" *CNBC*, Jan 22, 2009; and "John Thain Defends Merrill Lynch Bonuses Amid Bank Of America Takeover", *LA Times*, Jan 27, 2009.

America in 2008. He was also reported to have spent an additional \$1.2 million to renovate the new office he would occupy in the combined company. All these events happened at the time when Merrill Lynch reported an unexpected \$15 billion loss.

**Table 1: Exit Packages for Selected CEOs**

<b>Company</b>	<b>CEO</b>	<b>Date</b>	<b>Total</b>
Merrill Lynch	Stanley O'Neal	Oct. 28, 2007	\$161,000,000
Citigroup	Charles Prince	Nov. 4, 2007	\$105,000,000
Washington Mutual	Kery Killinger	Sep. 8, 2008	\$44,000,000
Wachovia	Ken Thompson	Jun. 1, 2008	\$42,000,000
Lehman Brothers	Richard Fuld	Sep. 17, 2008	\$24,000,000
Washington Mutual	Alan Fishman	Sep. 25, 2008	\$19,000,000
Freddie Mac <sup>1</sup>	Richard Syron	Sep. 8, 2008	\$16,000,000
Bear Sterns	James Cayne	Jan. 8, 2008	\$13,000,000
Merill Lynch	John Thain	Sep. 14, 2008	\$9,000,000
Fannie Mae <sup>1</sup>	Daniel Mudd	Sep. 8, 2008	\$8,000,000
AIG <sup>2</sup>	Robert Willumstud	Sep. 17, 2008	\$22,000,000 (declined)

*Source: USA Today - "CEO Pay takes a hit in bailout plan" Feb 10, 2008; James F. Reda & Associates*

*Note: 1 - CEO will receive only part of the exit package; 2 - AIG was taken over by the government; CEO Robert Willumstud voluntarily forfeited his \$22 million exit package*

The consequences of rent extraction can be considerable and are not limited to just the personal benefits extracted by these CEOs. Rent extraction causes inefficient allocation of resources whereby the addition money awarded to these CEOs could be used to reinvest in the firms' employees, operations, assets and/or capital. This translates into slower growth and poorer firm performance resulting in long term losses to the shareholders. In scenarios where CEOs extract personal benefits at the immediate expense of the shareholders such as agreeing to a lower takeover price of the company, the potential financial losses to the shareholders can be magnified.

To provide some context to begin my study, table 2 provides a breakdown of a typical CEO compensation structure. As seen from the table, there are two components in the typical CEO compensation that are unrelated to performance. I

focus on the lump-sum payments in golden parachutes and other extraordinary benefits<sup>3</sup> received by the CEOs when their firms are acquired. I aim to explore various possible determinants of these lump-sum payments to gain insights to CEOs' bargaining behaviors and the tools and tradeoffs involved with the hindsight of ultimately addressing the classic principal-agent problem. The question of how justifiable is the existing levels of annual compensation and/or other components of the CEOs' compensation are beyond the scope of this paper. It is, however, worth noting that the total monetary package paid to CEOs during takeovers (comprised of stock gains, accelerated vesting of stock options, pension plans and other non-disclosed benefits) would actually be much higher than the gains studied in this paper.

**Table 2: Typical CEO Compensation Structure**

Salary	<ul style="list-style-type: none"> <li>■ Typically a maximum of \$1 million dollars because of tax code</li> </ul>	Fixed Inome
Annual Incentive	<ul style="list-style-type: none"> <li>■ Paid in cash and/or stock</li> <li>■ Usually paid as a percentage of base salary</li> <li>■ Based on individual and/or company annual performance measures (financial, strategic, and /or operational)</li> </ul>	Performance Based
Long-Term Incentive Plan	<ul style="list-style-type: none"> <li>■ Paid in stock and/or stock options</li> <li>■ A reward for long-term performance (usually 3 years)</li> <li>■ Typical options vest based on the passage of time (3-6 years)</li> <li>■ Performance-based stock option grants vest based on earnings per share or stock performance</li> </ul>	Performance Based
Lump-Sum Payments	<ul style="list-style-type: none"> <li>■ Such as make-whole, golden-parachute, and change of control payments, as well as other contractually obligated payments</li> </ul>	Unrelated to Performance
Retirement Benefits / Others	<ul style="list-style-type: none"> <li>■ Defined-benefit plans and/or deferred-compensation plans</li> <li>■ Use of company aircraft and cars</li> <li>■ Consulting arrangement</li> </ul>	Unrelated to Performance

Source: J.Silvanya and K. Powers, "IRS Increases Scrutiny of Performance-Based Plans under Sec. 162(m) The Tax Adviser, Sept 1, 2008, 561-562.

<sup>3</sup> Extraordinary benefits are benefits that were not previously agreed upon but instead negotiated during the final stages of the takeovers. Extraordinary monetary benefits in my analysis include special merger-related bonuses and augmentation of existing parachute agreement. Extraordinary non-monetary benefits in my analysis include the post-acquisition positions occupied by the target CEOs in my sample.

In my study, I focus on mergers and acquisitions (M&A) because they represent high profile and externally observable corporate activities that present potential conflicts of interests between CEOs and shareholders. It is only during takeovers that the change-in-control agreement is triggered and the lump-sum golden parachute payment is awarded. For the less influential and capable CEOs, M&A also brings uncertainties to their future careers. For the more powerful and influential CEOs who had entrenched themselves within the firm, they are less likely to be replaced [Shleifer and Vishny (2003)]. M&A instead provides another opportunity for them to extract rent by negotiating additional favorable benefits for themselves. Given these circumstances, corporate takeovers provide an ideal setting to explore the efficiency and effectiveness of lump sum payments in aligning managerial interest with that of the company's shareholders.

I study 305 largest completed M&A deals from 1994 to 2003, concentrating my effort on the determinants of golden parachute gains received by CEOs due to their pre-contracted agreements and two other additional sources of gains during the final stages of the M&A negotiations: i) Augmentation of existing parachutes ii) One-time merger related cash bonuses. When these two variables are non-zero, they provide clear evidence that CEOs do indeed negotiate their own compensation. Market clearing rates cannot justify these gains, as the value of their human capital should have already been reflected in their existing compensation arrangement. Furthermore, as CEO compensation is reviewed and adjusted annually, the board of directors would have already updated any discrepancies in their perception of the CEO's value.

Merger cash bonuses and augmentation of parachutes have not been studied extensively in existing literature, as these two variables are not available in common

compensation databases such as ExecuComp. Hartzell, Ofek and Yermack (2004) is the first to collect information on these two variables by examining proxy filings of the firms in their sample. Grinstein and Hribar (2004) also obtain information from proxy filings to investigate cash bonuses awarded to CEOs of both acquiring and target firms when M&A deals are completed. I follow the same approach to get these data and CEOs' subsequent position in the acquiring firms by examining proxy filings before, during and after the transaction. I focus only on completed deals as they allow me to study the final stages of negotiations and the agreed-upon terms of the deal rather than a firm's attractiveness as a takeover candidate.

In my sample, 80.4 percent of the CEOs received a lump-sum golden parachute payment averaging \$2.2 million. In addition, 28.4 percent of the CEOs increased the size of their parachute by an average of \$2.9 million and 21.9 percent received average additional cash bonuses of \$3.2 million. Cross-sectional analysis of the determinants of these payouts reveals that measures of CEO personal characteristics such as years to retirement and share ownership explain part of the variation in total lump-sum amount received. Older CEOs closer to retirement are more able to secure larger lump-sum payouts, presumably due to their better negotiating skills. Share ownership reduces these payouts because appreciation of the company's share price would have provided the CEO with another source of wealth gain. Besides personal characteristics of the CEO, my results also indicate that the size and relative market capitalization of the target to the acquirer does provide some sort of bargaining power for greater payouts. I do not find any evidence that CEO lump sum payments are associated with the performance of the firm, which is also a common observable and quantifiable measure of the CEO's ability and performance.

When analyzing the additional payouts representing CEO bargaining behaviors, I learn that retained CEOs are more likely to bargain for these additional payouts. The positions CEOs occupy after the transaction do affect how successful they are in negotiating cash bonuses and size of golden parachutes. For cash bonus awards, CEOs retained in one of the top three management positions give up monetary gains in return for power and control. My results show that CEOs retained as lower ranking officers are 1.5 times more likely to receive cash bonuses than if they assume one of the top three positions. In the case of augmentation of parachutes, my study finds that CEOs of larger firms stand a better chance of bargaining about the size. Their success rates are likely to improve if the CEO takes on one of the top three positions but will be diminished by the size of existing parachutes.

Finally, my study also indicates that all extraordinary benefits received by target CEOs come at the expense of the firms' shareholders. The inverse relationship between takeover premium and CEO benefits is found to be most significant and strongest when the CEO assumes one of the top three positions of power. This suggests the possibility of CEOs agreeing to less favorable acquisition terms when they are presented with the opportunity to remain in a position of power in the combined company. I interpret these results to be consistent with the managerial power approach to executive compensation where executives have considerable power to influence their own pay and use that power to extract rent.

## 2. Literature Review

This study contributes to the vast collection of existing literature on executive compensation, providing evidence in support of the managerial power approach. In this approach CEOs have the power to influence the board over compensation decisions, which can result in suboptimal contracts. Bebchuk, Fried, and Walker (2002) and Bebchuk and Fried (2003) argue that when the board negotiates with an executive, they are predisposed to the executive's bargaining power and tactics. Powerful CEOs are more likely to succeed in extracting more rents in the form of compensation. They further illustrate how compensation arrangements that are favorable to executives but suboptimal to shareholders could also be accepted if shareholders perceive the arrangement to be justifiable. Corporate activities such as M&As provide easy justifications, whereby a manager could simply cite the extra time and effort he/she spent in constructing the deal as reasons for the additional compensation.

Other papers providing empirical evidence for this approach include Jensen (1993) who argues that CEOs control information flow to the board and set the agenda for board meetings, Yermack (1995) who finds that stock options are not awarded optimally and Weisbach (1998) who provides evidence that CEOs have the power to affect the selection of directors. Hartzel, Ofek and Yermack (2004) is the first to study rent extraction by means of the augmentation of parachutes and M&A bonuses received by target CEOs during corporate takeovers in the late 1990s. Their study suggests a possible financial tradeoff for career-related benefits that CEOs extract as they found evidence that CEOs who are retained after the transaction receive lower financial gains. Another paper documenting arguments in favor of self-

serving behaviors of CEOs includes Shleifer and Vishny's (2003) study on management entrenchment. Their paper outlines how managers entrench themselves by making manager-specific investments that make it costly for shareholders to replace them. As a result of this, managers reduce the probability of their being replaced, eventually gaining power and position to extract rent from shareholders.

Wulf (2003) studies abnormal returns in a sample of "merger of equals" and find evidence that target CEOs negotiate shared control in the combined firm at the expense of lower target shareholder premium. Grinstein and Hribar (2004) investigate M&A bonuses for CEOs of both acquiring and acquired firms and find positive correlation between bonus compensation and their effort in closing the deal. Consistent with the argument that managerial power is the main driver of M&A bonuses, they find that CEOs with greater power to influence board decisions receive significantly larger bonuses.

There are also studies exploring the relationship between managers' abnormal pre-acquisition compensation and the likelihood of the firms becoming a takeover target. Most of these studies build upon Fama's (1980) argument that the separation of security ownership and control can be an efficient form of economic organization. Individual participants in the firm, especially managers, are subject to the discipline and opportunities provided by the market for their service, both within and outside the firm.

Agrawal and Walking (1994) find that firms where CEOs have positive abnormal compensations are more likely to be acquired compared to other firms within the same industry. These CEOs are also more likely to be replaced and Agrawal and Walkling (1994) further discover that the post-bid compensation is negatively related to their pre-bid abnormal compensation, consistent with Fama's

(1980) notion of "ex-post settling up". Walkling and Long (1984) provide empirical evidence on the connection between managerial welfare and takeover bid resistance. They conduct tests on bid premium size, bidder nationality, conglomerate offers and "ex-post settling up" to determine their relationships with managerial actions. They find that the existence or absence of bid resistance to be positively correlated with the personal wealth changes of the target firm's managers. Loughran and Vijh (1997) examine post acquisition returns and the mode of acquisitions and the form of payment. Target shareholders who hold on to the acquirer stock received as a payment in stock mergers do not earn significantly positive excess returns but instead could sometimes earn negative excess returns.

Further extension of this area of literature highlights the role of the takeover market as a discipline mechanism to suppress abnormal CEO compensation. Martin and McConnell (1991) provide empirical evidence that highlights the role of the takeover market in controlling the non-value maximizing behaviors of top corporate managers. They find that the turnover rates for the top manager of a poorly performing target firm in tender offer-takeovers significantly increase after the takeovers. Parrino (1977) provides evidence that is consistent with prior arguments that poor CEOs are easier to identify and less costly to replace in industries that consist of similar firms than in heterogeneous industries

Other studies provided counterarguments to previous models. Palepu (1986) points out several methodological flaws in published studies that claim acquisition targets can be accurately predicted by models using public data. Narayanan and Sundaram (1998) find contrasting evidence to the claim that golden parachutes create incentives for managers to steer the firm to become an attractive takeover candidate. Their results suggest that golden parachutes have given managers the confidence to

restructure their firms and take bold initiatives that will be beneficial to the firm without the worry of losing their jobs while in the process.

Personal stock ownership represents one clear source of potential variation in target managers' attitudes toward selling their firms. Agrawal and Mandelker (1987) present evidence to support the hypothesis that CEOs holding shares of their own companies reduce agency problems. Denis, Denis and Sarin (1997) report that ownership structure significantly affects the likelihood of a change in top executive. Ownership structure also has an integral role in monitoring internal activities. Hartzel, Ofek and Yermack (2004) investigate the impact of stock-based compensation on managers' share ownership. They find that stock compensation increases the incentives of lower-ownership managers to align personal goals with shareholders goals but is not as effective for higher-ownership managers, as they will end up selling previously owned shares.

Some studies also examine the relationship between CEO compensation and CEO board power. Hallock (1997) point out that about 8% of CEOs are reciprocally interlocked with another CEO, with roughly 20% of firms having at least one current or retired employee sitting on the board of another firm and vice versa. He finds significant evidence that CEOs who lead interlocked firms earn higher compensation and tend to lead larger firms. Yermack (2006) studies separation payment, both voluntary and involuntary, and finds that more than half of the 179 Fortune 500 CEOs in his sample of study received severance pay and a mean separation package worth \$5.4 million. He points out that the large majority of severance pay is awarded on a discretionary basis by the board of directors and not in accordance to previously agreed employment agreement.

### **3. Data Description**

I analyze a sample of mergers and acquisitions that took place in the United States between 1994 and 2003 from the Securities Database Company (SDC) database. In my screening criteria, I require both the acquirer and target to be public U.S. companies and select the top 500 largest transactions sorted by transaction value. I choose to focus on large transactions because they represent significant corporate activities that are more likely to influence executives' compensation. I exclude cases where the transaction was either withdrawn or incomplete. This result in a sample of 353 M&A deals.

For each of the 353 deals, I examine the following SEC filings to obtain information on CEO's personal information, compensation, severance payments and post-acquisition positions: i) the last Proxy Statement before acquisition (Form 10-K, DEF14 or similar); ii) the Proxy Statement immediately after acquisition (Form 10-K, DEF14 or similar); and iii) Merger Proxy Statement (S-4, DEFM14A or similar). I eliminate firms where compensation information is not available. The final sample for my regression includes 305 CEOs.

#### ***3.1 CEO, firm and transaction characteristics of target***

Table 3 presents the summary statistics of the CEOs in my sample. An average CEO in the sample is 55 years old, owns 3.4 percent of the company's shares outstanding (*Share Ownership*), earns a base salary of \$585,000 (median \$529,000) and receives an annual bonus of \$669,000 (median \$360,000). The maximum total annual compensation (*Annual Comp*) in my sample is \$7,900,000. I calculate the

number of years to retirement (assumed at 65) *Yrs to Retirement* as the maximum of (65 - CEO's Age) or 0.

**Table 3: Descriptive Statistics**

	<b>Mean</b>	<b>Median</b>	<b>Maximum</b>	<b>Observation</b>
<b>A. Target CEO Characteristics</b>				
CEO base salary prior to acquisition (\$000)	\$585	\$529	\$2,714	305
CEO bonus prior to acquisition (\$000)	669	360	7,800	305
CEO total annual compensation (\$000)	1,176	857	7,900	305
CEO shares/shares outstanding	0.034	0.012	0.559	349
CEO age	55	56	81	349
CEO years to retirement	10	9	32	349
<b>B. Transaction Characteristics</b>				
Acquirer market capitalization 4 wks before offer (\$M)	\$17,724	\$7,035	\$326,646	349
Target market capitalization 4 wks before offer (\$M)	4,481	1,349	83,624	349
Relative Size (target market cap./(target+acquirer market cap.))	0.378	0.229	7.496	344
Unsolicited dummy	0.954	1.000	1.000	349
Total premium, 4 weeks, SDC data	0.432	0.358	2.556	346
<b>C. Target Firm Characteristics</b>				
Revenue (\$M)	\$4,826	\$1,532	\$164,747	335
EBITDA (\$M)	985	308	17,594	335
Total assets (\$M)	5,774	563	330,414	335
ROA (EBITDA/total assets)	2.177	0.232	44.671	335
Margin (EBITDA/revenue)	0.243	0.225	1.147	335

Descriptive Statistics about the target CEO's characteristics (ownership, compensation, age etc), transaction characteristics and firm characteristics. The sample includes 353 large transaction between 1994 and 2003. The sample is screened from the Securities Data Corporation which also provided information on transaction characteristics and the firm's financials. Information on target CEO's characteristics was collected from proxy statements filed during year immediately before the transaction. Proxy Statements were obtained from SEC's EDGAR database.

I also collect performance variables representing the size and the cash flow generating ability of the firm. The average size of target firm's assets (*Assets*) is \$5.8 billion (median \$555 million). Average annual revenue is \$4.8 billion (median \$1.5 billion) with earnings before interest, taxes, depreciation and amortization (EBITDA)

of \$985 million (median \$308 million). As there is a large disparity in the financial indicators of the firms in my sample, I divide EBITDA by both assets and revenues to obtain return on assets (*ROA*) and profit margin (*Margin*) respectively. I use *ROA* and *Margin* as indicators of performance across my sample. Average *ROA* is 2.2 percent (median 0.2 percent) while average *Margin* is 24.3 percent (median 22.5 percent).

Transaction value in the sample has an average of \$7.3 billion with a median \$1.9 billion. Out of all the transactions examined, only 4.6 percent of the transactions are unsolicited (*Unsolicited Dummy*). The average firm acquired has a market capitalization of \$4.48 million (median \$1.34 million) and the ratio of the acquired firm's market capitalization to the sum of the acquiring and acquired firms' market capitalization (*Relative Size*) has a mean of 0.378 (median 0.229). This ratio suggests some size discrepancy between acquirers and targets but not severe differences. Aside from measuring size discrepancy, *Relative Size* can also be interpreted as a proxy for bargaining power. CEOs of firms closer in size to the acquiring firms are likely to also have greater bargaining power during the M&A negotiations process.

The variable *Premium* is obtained from the SDC database and is defined as the difference between the acquirer's offer price and the pre-acquisition valuation of the firm 4 weeks (20 trading days) before the offer announcement. For stock considerations, SDC uses the pre-announcement value of the acquirer's stock price in the calculation instead of the target. The average takeover premium in my sample is 43.2 percent (median of 35.8 percent). Since the share price of the target firm often converges towards the acquirer's offer price by market forces, the SDC premium allows us to measure the changes in shareholders' value during the merger.

### ***3.2 CEO lump-sum payments and extraordinary benefits***

Mergers and acquisitions trigger the change-in-control agreements entitling the CEOs to additional severance compensation known as golden parachutes (*parachute*). The terms and conditions of the golden parachutes are often disclosed under the "Severance and Employment Agreement" section of the acquired firms' last proxy filings and/or the merger proxy filing. Golden parachutes are often specified as a lump-sum payment equal to a multiple of the CEO's salary and/or annual bonus. Common multiples equal three in many cases for tax purposes. Section 280G of the internal revenue code puts limitations on the corporate income tax deductions for golden parachute payments<sup>4</sup>. Other multiples encountered include 1, 2, 2.99 and 3.99 times the base compensation. For each CEO in my sample, I estimate the parachute payouts using these multiples as disclosed in the SEC filing<sup>5</sup>. Table 4 shows the merger related cash gains received by target CEOs. 80.4% of the CEOs in the sample received non-zero cash severance with an average parachute payment of \$1.75 million (median \$787,000).

On top of this, a sample of CEOs also received additional gains during the merger. I study two sources of additional gains in my analysis: i) Augmentation of the CEO's existing parachute and ii) Special merger-related cash bonuses. These gains are often not pre-agreed upon and are only negotiated during the final stages of the merger process when considering CEOs' post acquisition positions and CEOs' severance payouts. Although relevant to only a smaller sample of CEOs, these

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<sup>4</sup> Section 280G of the internal revenue code states the following: "if the present value of a change-in-control payment (golden parachute) exceeds the safe harbor (three times the average taxable compensation over the five most recent calendar years preceding the change-in-control, less \$1), the company loses tax deductions for these excess amounts. Additionally, the executive is required to pay a 20% excise tax on the excess payment."

<sup>5</sup> Like Hartzell, Ofek and Yermack (2004), I assume that all parachutes are triggered by the mergers and acquisitions in my sample. This may not be the case if the deal does not constitute a "change-in-control" necessary to activate the parachute

sources of wealth increase, especially in the extreme cases, are too significant for us to disregard. The largest augmentation of parachute in my sample is \$37.5 million and the highest cash bonus awarded is \$75.0 million.

**Table 4: CEO Private Benefits during M&A**

	<u>Mean</u>	<u>Median</u>	<u>Maximum</u>	<u>Observation</u>
<b>Target CEO Merger Cash Gains</b>				
Parachute (\$000)	\$1,754	\$787	\$27,197	305
Augmentation of Parachute (\$000)	829	0	37,500	305
Additional bonus (\$000)	698	0	75,000	305
Parachute dummy	0.804	1.000	1.000	305
Augmentation of parachute dummy	0.284	0.000	1.000	305
Additional bonus dummy	0.219	0.000	1.000	305
	<u>% of Total</u>	<u>Observation</u>		
<b>Target CEO Post Acquisition Positions</b>				
CEO Retained	0.500	156		
CEO Top 3	0.179	56		
CEO BOD	0.253	79		
CEO Officer	0.067	21		

Information was obtained from merger proxy filings (S-4 or equivalent) during the time of acquisition. Parachute payments are calculated based on information from the target company's proxy statement filed immediately before the transaction. Augmentation of parachutes and additional bonuses are one-time merger-related payments made to CEOs during the time of acquisitions. Information on these are collected from the merger proxy filings. CEOs post acquisition positions are obtained from both the merger proxy and the proxy filing of the acquirer immediately after the acquisition. CEO Retained is a dummy variable equal one if the CEO is retained after the acquisition. CEO Top 3 is a dummy variable equal one if the CEO assumes one of the top three positions in the combined company (usually CEO, Chairman or President). CEO BOD is a dummy variable equal one if the CEO sits on the board of directors of the combined company. CEO Officer is a dummy variable equal one if the CEO is retained as an officer of the combined company.

In my sample, 28.4% of the CEOs' golden parachutes are augmented by the target firm's board of directors during the merger. Negotiations, voting and approval of this increase happen in a closed boardroom and the decision is only made known to shareholders in an SEC filing. The average value of this increase across all CEOs in my sample is about \$829,000. Dividing this value by the frequency of 0.284 gives us \$2.9 million, which is the average increase for CEOs who do benefit from this source

of gains. I use dummy variable *AugPara\_Dummy* equals one if the CEO's experienced augmentation of parachute.

21.9% of the CEOs in my sample receive special cash bonuses as part of the agreement in the merger. The average cash bonus paid across all CEOs in my sample is about \$698,000. Again, dividing this value by the frequency of 0.219 gives us \$3.2 million - the average cash bonus payment. Dummy variable *CashBonus\_Dummy* equals one if the CEO received additional cash bonuses during the merger. Common justifications for these cash bonuses include consulting agreement, non-compete agreement, "retention"/"stay"/"transition" bonus, cancellation of CEO's employment agreement or other contract rights, "completion"/"success"/"integration" bonus and special "change-in-control" bonus. Table 5 shows the breakdown of these bonuses by justification and size.

**Table 5: Bonus breakdown by justification and size**

<i>Bonus Size</i>	Consulting Agreement	Non-Compete Agreement	Retention / Stay / Transition Bonus	Cancellation of existing contract / agreement	Completion / Success / Integration Bonus	Special Change-In-Control Bonus
More than \$5MM	6	10	4	3	2	0
\$1MM - \$5MM	12	6	11	7	8	2
Less than \$1MM	8	6	4	2	4	0
	26	22	19	12	14	2

I also collect information on the CEOs' positions after the transaction. CEOs' post-transaction positions are non-monetary benefits that have the potential to affect future streams of cash flow. If a CEO is retained, his opportunity cost of the transaction is not as large and I would expect a correspondingly lower severance payment made to the CEO. The amount of power or control that the CEO has in his/her new position is also a likely factor to influence severance compensation decision during the merger.

For each transaction, I examine the merger proxy and the annual proxy after the transaction to investigate if the CEO is being retained. Variable *CEO Retained* is the binary variable, which takes value 1 if the CEO is retained in any sort of position (to the extent disclosed in the filing) and 0 otherwise. For the CEOs who are retained I use 3 dummy variables *CEO Top 3*, *CEO BOD* or *CEO Officer* to categorize them. *CEO Top 3* equal 1 if the CEO assumes one of the three highest positions in the combined firm after the transaction. Common examples of these positions include being the CEO of the combined firm, the Chairman of the Board or the President of the firm. CEOs who are categorized as *CEO BOD* are those who are retained as a member of the Board of Directors. For the remaining sample of CEOs who are retained in any other positions, I categorize them as *CEO Officer*. The next page presents the correlation table of all the factors used in the regression.

Correlation Coefficients of Regression Variables

	CEO Characteristics			CEO Private Benefits During M&A					Target Firm Characteristics			Transaction Characteristics			
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII	XIV	XV
	Yrs to Retirement	Share Ownership	ln(Annual Comp)	CashBonus Dummy	AugPara Dummy	CEO Retained	CEO Top3	CEO BOD	CEO Officer	ln(Assets)	ROA	Margin	Premium	Relative Size	Unsolicited Dummy
<b>I</b>	1														
<b>II</b>	-0.04	1													
<b>III</b>	<b>-0.29</b>	-0.093	1												
<b>IV</b>	0.049	-0.025	<b>0.14</b>	1											
<b>V</b>	-0.073	-0.088	0.093	0.073	1										
<b>VI</b>	<b>-0.096</b>	-0.038	<b>0.15</b>	<b>0.212</b>	<b>0.119</b>	1									
<b>VII</b>	-0.031	-0.029	<b>0.103</b>	0.062	0.034	<b>0.443</b>	1								
<b>VIII</b>	<b>-0.144</b>	-0.006	<b>0.104</b>	0.09	0.073	<b>0.627</b>	<b>-0.226</b>	1							
<b>IX</b>	<b>0.099</b>	-0.025	-0.023	<b>0.178</b>	0.065	<b>0.301</b>	<b>-0.109</b>	<b>-0.154</b>	1						
<b>X</b>	<b>-0.173</b>	-0.044	<b>0.298</b>	0.021	<b>0.164</b>	0.051	-0.038	0.06	0.049	1					
<b>XI</b>	0.07	0.037	0.023	0.026	-0.028	0.046	0.021	-0.017	0.091	<b>0.249</b>	1				
<b>XII</b>	-0.082	-0.091	0.049	0.056	0.096	<b>0.169</b>	<b>0.119</b>	0.083	0.03	0.065	<b>0.236</b>	1			
<b>XIII</b>	<b>0.199</b>	0.052	<b>-0.168</b>	-0.037	-0.047	<b>-0.14</b>	-0.092	-0.075	-0.023	-0.062	-0.003	<b>-0.233</b>	1		
<b>XIV</b>	<b>-0.096</b>	<b>-0.109</b>	<b>0.114</b>	-0.031	-0.015	0.052	<b>0.151</b>	-0.031	-0.05	<b>0.126</b>	0.012	0.047	<b>-0.158</b>	1	
<b>XV</b>	0.071	0.082	<b>-0.132</b>	<b>0.125</b>	0.083	<b>0.166</b>	0.087	0.088	0.06	-0.052	-0.034	0.019	-0.003	0	1

Note: Correlation Coefficients that are significant at 10% levels are bolded. Yrs to Retirement is the maximum of 0 or (65 - CEO Age). Share Ownership is the % of common stock owned by the CEO at the event date. ln(Annual Comp) is the natural logarithm of the CEO's annual compensation (Base+Bonus) immediately prior to the takeover. CashBonus Dummy is a dummy variable equal one if additional cash bonus is given to the CEO during the merger. AugPara Dummy is a dummy variable equal one if the CEO's existing golden parachute is augmented during the merger. CEO Retained is a dummy variable equal one if the CEO is retained after the merger. CEO Top3 is a dummy variable equal one if the CEO assumes one of the top three positions (usually CEO, Chairman or President) in the combined company. CEO BOD is a dummy variable equal one if the CEO sits on the board of directors of the combined company. CEO Officer is a dummy variable equal one if the CEO is retained as an officer of the combined company. ln(Assets) is the natural logarithm of the size of the acquired company assets during the time of the transaction. ROA is defined as the acquired company's earnings before interest, taxes, depreciation and amortization (EBITDA) divided by the size of the assets. Margin is defined as the acquired company's EBITDA divided by the total revenue. Premium represents the Securities Database Company's (SDC) 4-week premium prior to offer date. Relative size is defined as the target firm's market capitalization divided by the sum of the both target and acquirer's market capitalization. Unsolicited Dummy is a dummy variable equal one if the transaction is not solicited by the target company.

#### **4. Regression analysis**

I first perform an OLS regression on the total lump-sum payments received by target CEOs. I infer that these payments are affected by target CEOs' personal attributes, personal benefits, performance and transaction characteristics. In instances where additional payments are made to CEOs, I run a logistic regression to explore factors that affect the likelihood of their receiving these payouts. In both regressions, I expect that if CEOs do negotiate with the acquirers over acquisition terms that affect them personally, there would be tradeoffs between their cash gains, post-acquisition positions and/or other personal benefits. I also hope to determine if these lump-sum payments provide evidence of negotiations and, if so, what factors influence how successful these CEOs are in negotiating.

Finally, I explore the relationship between CEOs' personal benefits and shareholders' value. I conjecture in my third regression that CEOs will only agree to lower takeover premiums if they receive prominent jobs in the management of the combined entity and/or receive special compensation arrangements. These arrangements are not related to equity and are in addition to the CEOs' pre-contracted agreement (eg. additional cash bonuses and/or augmentation of parachutes).

Collectively using all three regressions, I attempt to test the following hypotheses regarding how CEOs' cash gains are determined during M&A and also the pattern in which the CEO's tradeoff occurs:

1. CEOs with greater number of years to retirement should receive larger lump sum payments as they are giving up longer streams of future cash flow

2. CEO share ownership should be inversely related to lump sum payments but positively related to takeover premiums since it is more costly to negotiate control at the expense of premiums
3. CEOs of large (measured by size of assets and relative size of market capitalization to the acquirer) and better performing firms have greater bargaining power and thus are able to negotiate larger gains during takeovers
4. CEOs who are not retained after the acquisition should receive greater monetary benefits than those who are retained since they are giving up not only control and power but also streams of future cash flow that the job would otherwise bring in
5. CEOs who receive special monetary and/or non-monetary personal benefits during takeovers are more likely to agree to transactions with lower offer price

#### ***4.1 Determinants of CEO cash gains during mergers***

My estimating equation for CEO cash gains regresses the natural logarithm of total lump sum payments against a variety of factors representing CEO characteristics, CEO personal benefits, firm characteristics and transaction characteristics:

$$(1) \quad \ln(\text{Total lump sum payment})_i = \beta_0 + \beta_1 \text{Yrs to Retirement}_i + \beta_2 \text{Share Ownership}_i + \beta_3 \ln(\text{Annual Comp})_i + \beta_4 \text{CashBonus\_Dummy}_i + \beta_5 \text{AugPara\_Dummy}_i + \beta_6 \text{Retained}_i + \beta_7 \ln(\text{Assets})_i + \beta_8 \text{ROA}_i + \beta_9 \text{Margin}_i + \beta_{10} \text{Unsolicited}_i + \beta_{11} \text{Relative Size}_i + \beta_{12} \text{Premium}_i + \varepsilon$$

*Total lump sum payment* is the sum of the CEO's golden parachute, augmentation of the parachute and any additional one-time merger cash bonus. All other independent

variables are as defined in the previous section. Table 6 presents the regression results.

**Table 6: Determinants of CEO's total cash gains during mergers and acquisitions**

	Ln(Total Merger Gains)					
	I	II	III	IV	V	VI
Constant	<b>0.407</b> (0.46)	<b>1.475</b> (1.97)	<b>1.610</b> ** (2.15)	<b>1.293</b> (1.6)	<b>13.943</b> *** (37.1)	<b>13.701</b> *** (32)
<b>CEO Characteristics</b>						
Yrs to Retirement	<b>-0.0176</b> *** (-2.61)	<b>-0.0198</b> *** (-3.5)	<b>-0.0166</b> *** (-2.84)	<b>-0.0175</b> *** (-2.99)	<b>-0.0354</b> *** (-4.39)	<b>-0.0324</b> *** (-3.52)
Share Ownership	<b>-0.0193</b> *** (-2.73)	<b>-0.0155</b> *** (-2.63)	<b>-0.0146</b> ** (-2.52)	<b>-0.0139</b> ** (-2.39)	<b>-0.0202</b> ** (-2.49)	<b>-0.0251</b> *** (-2.7)
ln(Annual Comp)	<b>1.071</b> *** (16.97)	<b>0.965</b> *** (18.06)	<b>0.921</b> *** (16.63)	<b>0.928</b> *** (16.54)		
<b>CEO Personal Benefits</b>						
CashBonus_Dummy		<b>0.751</b> *** (8.56)	<b>0.732</b> *** (8.41)	<b>0.743</b> *** (8.54)	<b>0.956</b> *** (7.91)	
AugPara_Dummy		<b>0.528</b> *** (6.68)	<b>0.534</b> *** (6.63)	<b>0.538</b> *** (6.7)	<b>0.557</b> *** (4.94)	
CEO Retained		<b>0.0927</b> (1.22)	<b>0.0550</b> (0.72)	<b>0.0622</b> (0.81)	<b>0.213</b> ** (1.98)	<b>0.395</b> *** (3.27)
<b>Firm Characteristics</b>						
ln(Tar_Assets)			<b>0.0217</b> ** (2.43)	<b>0.0209</b> ** (2.34)	<b>0.0573</b> *** (4.72)	<b>0.0732</b> *** (5.4)
ROA			<b>-0.00215</b> (-0.4)	<b>-0.00261</b> (-0.49)	<b>-0.00559</b> (-0.75)	<b>-0.00882</b> (-1.04)
Margin			<b>0.154</b> (0.63)	<b>0.258</b> (1.03)	<b>0.121</b> (0.34)	<b>0.309</b> (0.77)
<b>Transaction Characteristics</b>						
Unsolicited_Dum				<b>0.0199</b> (0.11)	<b>-0.488</b> * (-1.93)	<b>-0.204</b> (-0.71)
TarMV/(TarMV+AcqMV)				<b>0.363</b> * (1.86)	<b>0.545</b> ** (1.99)	<b>0.339</b> (1.09)
Premium				<b>0.00235</b> ** (2.21)	<b>0.000529</b> (0.36)	<b>0.000242</b> (0.14)
Observations	305	305	292	292	292	292
Adjusted R-Square	54.7%	68.7%	69.6%	70.1%	41%	23%

Note: Standard errors are in parentheses.

\*\*\*, \*\* and \* represents significance at 1%, 5% and 10% level.

One can expect the coefficient estimates of *AugPara\_Dummy*, *CashBonus\_Dummy* and *lnAnnual Comp*) to be highly significant and correlated with the dependent variable as the dependent variable is constructed from these factors. The coefficient estimates of these factors simply tell us the magnitudes of their contributions to the total gains - if the CEO receives additional cash bonuses, total

cash gains increase more than 70 percent and if the CEO's parachute is augmented, total cash gains increase more than 50 percent. What is more interesting in the regression model is how the coefficient estimates of the other factors in the model change when the three variables above are controlled for. I will study the determinants of augmentation of parachute and additional cash bonuses separately in the next section.

Overall, the results in Table 6 are very similar across all specifications. The number of years before the CEO retires at 65 and the share percentage owned are both negative and significant in all specifications. The *Yrs to Retirement* coefficient ranges between -0.0166 (Column III) and -0.0354 (Column V), indicating that younger CEOs receive less cash lump sum payments. This relationship contradicts my initial hypothesis that younger CEOs are expected to receive more cash gains to compensate for the loss of future cash flows and benefits. One possible interpretation of this result is that older CEOs are more likely to extract greater personal benefits during a merger because they have fewer outside employment opportunities as younger CEOs. Alternatively, we can also view older CEOs as being more experienced, thus more influential when it comes to their ability to negotiate more favorable compensations with the board of directors. Bebchuk, Fried and Walker (2002) argue that increases in CEO compensation not only depend on the power of the CEO but also how shareholders interpret the compensation arrangements. If shareholders interpret the arrangements as the CEOs bluntly appropriating value from the firm, they are likely to act against them. Mergers and acquisitions provide an opportunistic moment for CEOs to justify a more favorable compensation by citing the extra effort and time involved in constructing the deal.

Share ownership by the CEO reduces the incentives and ability of CEOs to extract personal benefits of control at the expense of shareholders. The coefficient estimate for *Share Ownership* ranges between -0.0251 (column VI) and -0.0139 (column IV) indicating that CEOs who hold more shares of the company receive lesser cash gains during a takeover. This is in line with my initial expectation and should not be surprising. The share price of a firm usually appreciates by the takeover premium; thus, the greater the CEO's share ownership, the more wealth he/she will gain during the merger. CEOs with large share ownership will find it more difficult to justify any additional compensation during a merger. This result is consistent with Agrawal and Gershon (1987) who found significant evidence that awarding CEOs shares of their own companies helps mitigate agency problems by aligning the CEO's objective with that of the shareholders.

The effect of firm size and bargaining power on CEO's cash gains is consistent with my hypothesis. The coefficient estimates of  $\ln(Assets)$  suggest that CEOs total cash gains during a takeover increase between 2.09 percent (Column IV) and 7.32 percent (Column VI) for every percentage increase in the firm's asset size, compensating them for their greater abilities to manage larger firms. CEOs of companies whose relative size is closer to that of the acquirer (my proxy for bargaining power), are also more successful in extracting greater cash gains. According to the model, *Relative Size* has positive significant coefficient estimates when I control for the  $\ln(Annual\ Comp)$ , *CashBonus\_Dummy* and *AugPara\_Dummy* in column IV (Coefficient = 0.3625, T-Statistic = 1.86) and column V (Coefficient = 0.5451, T-Statistic = 1.99).

I expect CEOs who are retained after the acquisition to receive greater cash gains during the merger as they surrender future streams of income but estimates for

*CEO Retained* suggest otherwise. There are two possible interpretation of this result. The first interpretation is that merger cash gains are used as incentives to retain the good CEOs to work in the combined company. If this argument is true, we can expect CEOs retained at higher positions in the combined company to be paid more than CEOs retained at lower positions, as the value of their human capital to the acquirer is higher. The second interpretation of the result is that CEOs who are retained during the merger are the ones more likely to extract greater monetary benefits during the merger. In this scenario, I infer that CEOs will still engage in tradeoffs between power and monetary benefits. I expect CEOs who assume positions of power in the combined company to have lower ability to extract benefits during mergers. I will revisit these two arguments again in the next section when I explore factors affecting the likelihood of a CEO receiving additional cash benefits during a merger.

Measures of the financial performance (*ROA* and *Margin*) of the target firms in my sample yield no significant results in all specifications, providing no evidence that CEOs' total cash gains during mergers are influenced by the performance of the firm. This is in line with the argument that these lump sum payments are not linked to the performance of the CEOs [Bebchuk and Fried (2003)]. Other estimates such as *Unsolicited* and *Premium* are weakly significant in specification V and IV respectively but are not robust across other specifications making it difficult to make any conclusions.

#### ***4.2 Likelihood of additional cash gains during mergers***

To better understand the relationship between additional merger cash gains received by CEOs and their post-transaction positions, I attempt to determine the probability of a CEO receiving additional cash gain during a merger (represented by

both *AugPara\_Dummy* and *CashBonus\_Dummy*) based on factors found to be significant in regression 1. I include an additional factor  $\ln(\text{CEO Parachute})$  that measures the magnitude of the CEOs' existing parachute based on a pre-contracted employment agreement and exclude  $\ln(\text{CEO Annual Comp})$  as this factor is highly correlated with  $\ln(\text{CEO Parachute})$ . I also decompose the dummy variable that represents whether the CEO is retained into the three dummy variables representing the positions assumed - *CEO Top 3*, *CEO BOD* and *CEO Officer*. I estimate the probabilities of receiving additional cash bonuses and augmentation of parachute using the following multiple logistic regression model:

$$(2) \quad \text{Probability (Additional Gains)} = f(\text{CEO attributes and post-acquisition positions, pre-contracted parachute, firm and transaction characteristics})$$

The results of the above regression are presented in Table 7. Regression results in column I and II suggest that the only factor that affects the probability of receiving additional cash bonuses during mergers is whether the CEO is retained. All coefficient estimates representing whether the CEO is retained are positive and significant. A closer look at the magnitude of the coefficients reveals that CEOs retained as just officers are about 1.5x more likely to receive additional cash bonuses than CEOs retained in one of the top three positions or if the CEO assumes directorship. This implies that CEOs who are forced to give up power and control as a result of the merger are more likely to extract greater benefits when the news is made known to them during the final negotiation stages.

**Table 7: Logit Specification - CEO Additional Merger Related Gains  
(Cash Bonus and Augmentation of Parachute)**

	Dependent Variable is Dummy equal to 1 if the CEO receives the following:			
	A. Merger Cash Bonus (= 0 or 1)		B. Augmentation of Parachute (= 0 or 1)	
	I	II	III	IV
Constant	<b>-1.306</b> (-1.39)	<b>-1.311</b> (-1.39)	<b>-2.012</b> (-1.43)	<b>-2.019</b> (-1.43)
Yrs to Retirement	<b>0.0245</b> (1.11)	<b>0.0214</b> (0.96)	<b>-0.00928</b> (-0.41)	<b>-0.0101</b> (-0.45)
Share Ownership	<b>-0.00243</b> (-0.11)	<b>-0.00143</b> (-0.06)	<b>-0.0414</b> (-1.55)	<b>-0.0410</b> (-1.54)
CEO Retained	<b>1.039 ***</b> (3.62)		<b>0.602 **</b> (2.16)	
CEO Top 3		<b>0.951 **</b> (2.37)		<b>0.661 *</b> (1.66)
CEO BOD		<b>0.929 ***</b> (2.74)		<b>0.535</b> (1.62)
CEO Officer		<b>1.519 ***</b> (3.02)		<b>0.723</b> (1.33)
ln(Parachute)	<b>-0.0422</b> (-1.34)	<b>-0.0392</b> (-1.23)	<b>-0.156 ***</b> (-4.31)	<b>-0.155 ***</b> (-4.27)
Premium	<b>-0.00256</b> (-0.6)	<b>-0.00241</b> (-0.56)	<b>0.000590</b> (0.15)	<b>0.000608</b> (0.16)
ln(Tar_Assets)	<b>0.0134</b> (0.4)	<b>0.0120</b> (0.36)	<b>0.175 ***</b> (2.94)	<b>0.175 ***</b> (2.95)
ROA	<b>0.00444</b> (0.21)	<b>0.00247</b> (0.12)	<b>-0.0169</b> (-0.58)	<b>-0.0178</b> (-0.61)
TarMV/(TarMV+AcqMV)	<b>-0.772</b> (-0.91)	<b>-0.676</b> (-0.78)	<b>-0.854</b> (-1.11)	<b>-0.874</b> (-1.12)
Observations	297	297	297	297
Pseudo R-sq				

Note: Standard errors are in parentheses.

\*\*\*, \*\* and \* represents significance at 1%, 5% and 10% level.

In column III on the right side of the table, we see that although the regression estimates of *CEO Retained* are positive and significant, they are somewhat weaker in predicting the probability of an augmentation of parachute than it did for cash bonuses. Of the 3 dummy variables representing the different post-acquisition positions in column IV, only *CEO Top 3* is significant at the 10 percent level. This means that CEOs who are retained as one of the top positions of the combined company are more likely to succeed in negotiating for additional gains by means of augmentation of parachute. The more significant factors in predicting the probability

of parachute augmentation seems to be the size of the firm and the size of the CEO's existing parachute. Coefficient estimates of  $\ln(\text{Assets})$  and  $\ln(\text{Parachute})$  suggest that CEOs of large firms are more likely to succeed in increasing the size of their parachute but their success rates are somewhat diminished by the size of their existing golden parachutes

### ***5.3 Tradeoff between CEO personal benefits and shareholders value***

In this regression, I am interested in how personal benefits representing extraordinary treatment of the CEOs affect shareholders' value. CEOs are "agents" of the company's shareholders and it follows that their compensation must be aligned to the interests of the owners of the company, most directly by maximizing shareholders value. "Shareholders value" is usually measured by the company's stock price and/or dividends per share but in the case of a merger, it is the acquisition premium offered by the acquiring company. Acquisition premium in my regression is the difference between the actual price offered by the acquirer and the pre-acquisition valuation of the firm 4 weeks (20 trading days) before the announcement. To test hypothesis 5 presented above, I conjecture that acquisition premium is negatively correlated with all CEO personal benefits. I provide 3 specifications of my regression in table 8 that test the following relationship:

$$(3) \quad \text{Acquisition Premium} \propto \frac{1}{\text{CEO Personal Benefits}}$$

The first specification regresses acquisition premiums on only CEO personal benefits representing extraordinary treatments during mergers. The second and third include additional controls for the CEO's attributes and the firm's characteristics.

Although not significant except for when the CEO is retained in one of the top three positions, the inverse relationship seems to be obvious. The negative coefficients in the regression for the dummy variables representing extraordinary treatment are consistent with my hypothesis that CEOs do negotiate less favorable terms for the shareholders when the transactions include additional gains for the CEO, either in the form of additional monetary gains and/or new employment opportunities.

The negative correlation is strongest when the CEO is retained as one of the top three positions. Coefficient estimates for *CEO Top 3* is most negative and significant across all 3 specifications, indicating that shareholders are worst off when the CEO of the target company takes on a position of power in the combined company. From my regression results, average premium could be lowered by between 9.2 percent and 13.0 percent when the CEO is retained as one of the top three positions. This result is consistent with my earlier hypothesis on how CEOs would only agree to lower acquisition premiums if they are guaranteed lucrative positions in future. In this case it is one of the top 3 most powerful positions in the combined company.

**Table 8: Trade-off between CEO private benefits and shareholder premiums**

	Target Return (Premium), 20 days		
	I	II	III
Constant	<b>0.469 ***</b> (17.82)	<b>0.563 ***</b> (4.15)	<b>0.762 ***</b> (4.74)
<b><u>CEO Characteristics</u></b>			
Yrs to Retirement	✓	<b>0.00797 ***</b> (3.47)	<b>0.00551 **</b> (2.34)
Share Ownership	✓	<b>0.00216</b> (0.8)	<b>0.000618</b> (0.23)
ln(Annual Comp)		<b>-0.0151 *</b> (-1.69)	<b>-0.00732</b> (-0.79)
<b><u>CEO Private Benefits</u></b>			
CashBonus_Dummy	✓	<b>-0.0408</b> (-0.91)	<b>-0.0473</b> (-1.1)
AugPara_Dummy	✓	<b>-0.0506</b> (-1.26)	<b>0.00640</b> (0.16)
CEO Top 3	✓	<b>-0.130 **</b> (-2.52)	<b>-0.108 **</b> (-1.82)
CEO BOD	✓	<b>-0.0455</b> (-1.01)	<b>-0.00867</b> (-0.2)
CEO Officer		<b>-0.0446</b> (-0.56)	<b>-0.0500</b> (-0.66)
<b><u>Firm Characteristics</u></b>			
ln(Tar_Assets)	✓		<b>-0.00894 **</b> (-2.31)
ROA	✓		<b>0.00729 ***</b> (2.98)
Margin			<b>-0.531 ***</b> (-4.61)
Observations	305	305	292
Adjusted R-Square	7.5%	13.6%	69.6%

Note: Standard errors are in parentheses.

\*\*\*, \*\* and \* represents significance at 1%, 5% and 10% level.

## **5. Conclusion**

Using a sample of large completed merger and acquisition transactions between 1993-2004, I investigate extraordinary benefits received by target CEOs that are not part of the existing employment contract. These benefits provide evidence consistent with the managerial power approach. Consistent with the argument put forth by Bebchuk, Fried and Walker (2002) and Bebchuk and Fried (2003), I found evidence that CEOs do engage in some sort of negotiations with the board, allowing CEOs with greater bargaining power and skills to receive greater compensation.

In my sample, 80.4 percent of the CEOs have golden parachute agreements in place and stand to receive an average lump sum payment of \$1.8 million with a median of \$787,000 if the change-in-control agreements are triggered. During the final stages of the merger, some CEOs also receive additional monetary benefits when the transaction is approved. 28.4 percent of the CEOs have their golden parachute increased and 21.9 percent received additional merger-related cash bonuses. Average gains from these sources range between \$2 to \$3 million and this is in addition to the golden parachute and all other merger gains received by the CEOs.

The total lump sum payments received by the CEOs are strongly influenced by the CEOs personal characteristics, size of the firms they manage and their post-acquisition positions. I find that CEOs with larger percentage of share ownership are less likely to be involved in rent extraction behaviors, consistent with Denis, Denis and Sarin (1997) and Agrawal and Mandelkar (1987). The positive significant relationship between compensation and size is also in line with existing literature such as Yermack (2006), Grinstein and Hriber (2004) and Wulf (2003). CEOs' bargaining power in my analysis, measured as relative market capitalization of the target firm to

that of the acquirer, also seems to be a factor that positively correlates with the total lump sum payments received.

I also find these lump sum payments to be unrelated to the firm and CEO's performance indicators. Although not thorough in representing the performance of CEOs and their firms in my analysis, the large size of these lump sum payments and the lack of connection with performance in my analysis suggest overcompensation and should raise a cause of concern for the shareholders. In their book, Bebchuk and Fried (2005) further provide more studies and analyses on this issue as well as top executives' pay practices and the corporate governance processes that produce them.

My analysis of the two additional sources of gains provides further insights into CEO bargaining behaviors and the tools and tradeoffs involved. I find that among the CEOs who are retained, those retained in the top positions are less likely to receive merger cash bonuses compared to those retained in lower positions. This means that when CEOs are presented with the opportunity, they are willing to trade short-term monetary gains in return for power, control and longer-term rent extraction ability. On the other hand, CEOs negotiating for an increase in their golden parachute tend to be more successful if they are retained as one of the top positions. The success rates will also be higher for CEOs of larger firms but are significantly diminished by the existing size of their golden parachute.

Finally, my results indicate that the extraordinary personal benefits received by CEOs during mergers are negatively related to the takeover premium offered to shareholders. This negative relationship is significant and most negative when the CEO assumes one of the top three positions in the combined company. The results of this analysis highlight an agency problem whereby CEOs choose to maximize their personal benefits during mergers and acquisitions rather than the shareholders' value.

The greatest concern implied by the results is that CEOs would sometimes agree to lower acquisition prices if they are guaranteed lucrative positions in the future. If this implication is true, the few percentage point decrease in takeover premium could magnify into economic losses to target shareholders that substantially exceed the benefits received by the CEO. This result complements Wulf (2003) and is consistent with Hartzell, Ofek and Yermack (2004) study, both of which found evidence that target CEOs accept lower takeover premiums in return for either shared control or additional financial gains.

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