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# Exploring the Relationship Between Executive Compensation and Corporate Mergers and Acquisitions

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# EXPLORING THE RELATIONSHIP BETWEEN EXECUTIVE COMPENSATION AND CORPORATE MERGERS AND ACQUISITIONS

By

Akiva Stern

A Major Research Paper
Submitted to the Faculty of Graduate Studies
Through the Odette School of Business
in Partial Fulfillment of the Requirements
for the Degree of Master of Business Administration at the
University of Windsor

Windsor, Ontario, Canada

2018

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Exploring the Relationship Between Executive Compensation and Corporate Mergers and Acquisitions

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## ABSTRACT

Corporate Governance is one of the most important aspects of corporate life. The role requires individuals to have a moderate, if not excellent command of not only the industry they are operating within, but the basic tenants of many disciplines including law and finance. It is therefore important to not only view how these disciplines contribute to their knowledge individually, but also how they might work together to provide a better insight into governing a company on a day-to-day basis.

A predominant decision that often comes under scrutiny is the relationship between executive compensation and M&A Activity. This paper takes a multi-disciplinary approach to corporate governance by looking at the legal and financial motivations and obligations of directors and officers as they pertain to M&A activity, in order to gain insight into the legal and behavioural theories that drive their actions.

The paper will summarize studies outlining the paradoxical interests of directors and officers as representatives of the corporation and shareholders, in the context of M&A activity. This study will combine those insights with the legal landscape, in order to make recommendations with respect to best practices of directors and officers and contribute to the foundational knowledge on Corporate Governance.

# DEDICATION

To my future wife.

# ACKNOWLEDGEMENTS

I am very grateful to have such a supportive peer group throughout my time at both faculties. Thank you to my supervisor, Eahab Elsaid who always supported my enthusiasm and curiosity towards this project. Thank you to Bharat Maheshwari who I will always remember as my intellectual confidant. A very sincere thank you to Adriano Durante who patiently worked alongside me and assisted me far too generously in collecting data and creatively working around many stumbling blocks along the way. Lastly, thank you to all those who answered my frantic Facebook messages and late night emails offering assistance without hesitation. We are only the sum of the energy of the people around us.

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# NOMENCLATURE

“Acquisition” – An acquisition is a corporate action in which a company buys most, if not all, of another firm’s ownership stakes to assume control of it. An acquisition occurs when a buying company obtains more than 50% ownership in a target company. As part of the exchange, the acquiring company often purchases the target company’s stock and other assets, which allows the acquiring company to make decisions regarding the newly acquired assets without the approval of the target company’s shareholders. Acquisitions can be paid for using cash. In the acquiring company’s stock or a combination of both.

“Agency Theory” – Agency theory explains the relationship between principals and agents in business. Agency theory is concerned with resolving problems that can exist in agency relationships due to unaligned goals or different levels of risk aversion.

“CEO Duality” – The notion that a CEO will hold more than one position, and therefore have to act in more than one capacity in the organization. For example, when the CEO is also the Chair of the Board of directors.

“Compensation Mix” – Compensation Mix describes the different components of compensation and how they form into one structure to compensate employees. The

most common types of compensation that make up this mix is base pay and incentive pay, such as Employment Stock Option plans.

“Directors & Officers” – Directors are responsible for supervising the activities of the corporation and for making decisions regarding those activities. Officers are responsible for the day-to-day operation of the corporation, which includes positions such as CEO and other C-Suite positions within a company.

“Earnings-Management” – Earnings Management is the use of accounting techniques to produce financial reports that present an overly positive view of a company’s business activities and financial position.

“Equity Based Compensation” (“**EBC**”) – EBC is a non-cash pay that represents ownership in a company. This type of compensation can take many forms, including options, restricted stock and performance shares. ECB allows the employee of the company to share in the profits via appreciation and can encourage retention.

“Employee Stock Option” (“**ESO**”) – An ESO is a stock option granted to specified employees of a company. ESO’s offer the option holder the right, but not

the obligation, to buy a certain amount of company shares at a predetermined price for a specific period of time.

"Fiduciary Duty" – A legal term describing the relationship between two parties that obligates one to act solely in the interest of the other. The party designated as the fiduciary owes the legal duty to a principal, and strict care is taken to ensure no conflict of interest arises between the fiduciary and his principal. Any individual person, corporation, partnership or government agency can act as a principal or agent as long as the person or business has the legal capacity to do so.

"Non-Equity Compensation" – Compensation that does not come in the form of an ownership stake in a particular company. Typically Non-Equity Compensation is referred to cash compensation and can often be triggered by successfully closing an M&A transaction.

"Pay for Performance (Merit Pay)" – An approach to compensation that rewards the higher performing employees with additional pay or incentive pay.

# CHAPTER 1
# MULTIDISCIPLINARY APPROACH TO LAW AND FINANCE

*Introduction*

Corporate Governance is a very loaded term. Broadly defined, it is a "system of rules, practices and processes by which a company is directed and controlled. It involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community" (Investopedia, 2018). It includes more and more as the gamut of executive responsibilities widens to incorporate more legal and managerial obligations. Further, what they may be legally obliged to do may not include some of the above stakeholders in question. What they must do in actuality, in order to be successful, is in fact far more complex because there is a component of self-interest in their roles.

The real essence of proper corporate governance is the notion that the decisions one makes as a director or officer should be done in a conscientious way so as to not welcome liability, and create a sound process for how the corporation should run. This includes, as we will see later on, the notions of fiduciary obligations and a duty of care. This topic stemmed from those issues that merge multiple stakeholders in a multi-disciplinary lens adding to the already critical lens of executive action. It seeks to ask the question; how do all the obligations interact and what issues arise as a result?

One such topic is the role of directors to set out a compensation scheme that best motivates executive officers to engage in behaviors that most benefit the corporate entity, the more popular of those behaviors being merger and acquisition activity. With

historical issues of conflicting objectives between the officers and their shareholders being as ever present as always, this paper sought to examine the relationship between executive compensation and M&A activity, in order to learn more about the literary landscape and combine it with current legal obligations of these officers.

The role of compensation in M&A activity began raising certain enquiries such as; is there a premium on compensation for executives in consolidation deals, does the expediency of a deal justify a premium on compensation rather than through natural internal growth, should this discourage shareholders, and ultimately does it even matter for their long term return?

This paper will act as a meta-analysis that seeks to explore and discuss the relationship between executive compensation and company driven acquisitions with respect to shareholder return, calling into question whether the officers and directors of a company are pulling their weight to bring value to shareholders, as opposed to simply driving/executing on their compensation structures.

The paper is organized into seven sections. The first section will explain the reason for the paper, provide the research question and discuss the relevance of the topic. The second section will discuss the methodology used in obtaining information and findings for the paper. The third section will provide the literature review that comprises the content for the main meta-analysis of the discussion section. This includes covering research on the topics of; (a) Mergers and Acquisitions, (b) Regulatory and Legal Landscape of Directors & Officers and their obligations to the corporation they serve, (c) the Socio-Psychological frameworks that drive agency issues, and (d) the effects of

executive compensation on M&A activity. The fourth section will summarize the findings of the literature review and offer several themes prevalent in the research. The fifth section will provide a brief conclusion to the findings. The sixth section will briefly discuss limitations of the research and provide suggestions for areas of future research.

*Research Question*

The research question in brief is as follows: What factors are significant with respect to the relationship between compensation and M&A activity? This paper intends to unravel what compensation factors motivate officers to act selflessly or selfishly when it comes to corporate decision-making. It will look at how compensation schemes are developed and whether the justification for their structure is justified. Finally the paper will look at whether shareholders benefit at all from these activities proportionate to the types of compensation an officer might receive for engaging in this kind of activity.

*Relevance*

As a JD/MBA student, I am often propelled into multi-disciplinary lenses that meld theories to better understand a situation. During my degree, I had the benefit of acting as the Managing Director of the Odette Business School's Student Investment Fund, where I contributed to the development of the fund's by-laws and constating documents. I witnessed, first hand, how the trustees and other administrative stakeholders worked diligently to construct a fund that would serve the altruistic objectives of the student body and donor, while still strongly including objectives that they felt needed to

be represented in an initiative of this nature. This could also be seen on the student side, where Fund Managers and Analysts alike would attempt to assertively push investments that they felt strongly about, even if it did not align with the spirit of the fund's investment policy. This led to further clarifications with respect to investment and monitoring criteria such as a ban on all 'Sin Stocks' including tobacco and marijuana companies. The effect of these restrictions are further exacerbated by the relationship between the real professional world of finance and investing and academia, particularly when many millions of dollars have been poured into marijuana stocks on speculation, and is seen as a completely rational and encouraged behavior as of late. It also forced us to forgo higher returns in 'exciting' investments because they were too risky based on the Fund's goals. It is clear then that there was two baskets of interests, one personal, and one professional, that each of us needed to delineate between, in order to do our jobs and act in the best interest of the fund.

Furthermore, there is a legal side to decision-making that stems beyond personal interests and objectives. Fiduciary duty is an important pillar of business law. The executive officers then, must be scrutinized to make sure they are in line with their duty. This results in asking the question of whether buyers are paying a fair price for their purchases when the selling entity is not directly benefitting. A closer look at the financing side of these deals will shed light on the nature of the relationship posed above. If executive officer's are compensated in a way that forces them essentially to take on more active M&A activity despite the real returns to shareholders, then there is a legal conundrum of conflicting interests and decisions that are not being made within the scope of their legal duties.

To that end, this paper sheds light on a few conclusions that are not readily intuitive to directors & officers with respect to this relationship. It combines knowledge from various disciplines and offers a unique perspective on how all these topics interplay to create several statements about how power people behave.

# CHAPTER 2
# METHODOLOGY

The main method used for this paper is meta-analysis. I conducted a literature review of articles related to the relationship of executive compensation on M&A activity and aggregated them in a way that would allow me to derive several broad principles. This added effect contributes to the body of knowledge where one specific study could not. This literature review was done traditionally using various research strings in major databases such as Google Scholar, ABI Inform and Proquest, leading databases on management research journals. Additionally, I followed up with certain citations within the articles to pursue any publications that provided a deeper discussion on the topic.

For the legal component, I used materials from various business law courses, including Business Associations and Corporate Finance where a large portion of the course is devoted to obligations of directors & officers and their legal duties.

Lastly, I used my experiences as a managing director of the John Simpson Odette Student Investment Fund for two years during my degree, where I had to manage the directives and interests of a board of trustee's along with a team of Fund Managers and Analysts who run the fund on a day-to-day basis and are primarily responsible for the investment decisions of the fund.

# CHAPTER 3
# LITERATURE REVIEW

*Introduction to Mergers and Acquisitions*

In order to understand the basic motivation for why executives conduct mergers or acquisitions during their tenure, we must briefly outline what these business transactions are for. In addition to growing the company from the inside, i.e. develop the company's current service or product to increase growth, companies can engage in M&A in order to expedite growth at a much faster rate (e.g. Cooper, Gulen and Schill, 2008). A Merger is when two companies combine under one entity, whereas an acquisition is when a company buys another outright. For the purpose of this paper we will not address asset purchases, although this is another way to expedite growth.

Companies engage in this kind of activity for a number of reasons. For starters, M&A is the fastest way to acquire market share and remove competition. Then due to more simplistic reasons like economies of scale and scope, companies can use that increase in capital and production capacity to lower their overhead costs and either create a higher profit margin or offer products at more competitive pricing, increasing their overall sales. This is seen very heavily in the Swiss watch industry where companies began acquiring suppliers of movement parts to control the quality of their product and bring down costs.

Given the time sensitive demands of companies on their directors and officers to produce results during their tenure, it is no surprise then that this avenue seems highly attractive. Companies over time began linking compensation pay to number of

acquisitions or ‘deal-flow’ so that an incentive was created for CEO’s to grow companies faster and provide better returns for shareholders. The remaining question then is to what extent is this positive reinforcement scheme actually creating quality deals versus simply increasing the *quantity* of deal-flow? Further, is there a statistically proven rate of return to shareholders in the long run versus creating inflated, but illusory, gains based on speculation. If the case is the latter, then we have a scenario where the Board of Directors is creating a compensation scheme that reinforces the issues inherent in basic agency theory.

### *The Regulatory and Legal Landscape*

As explained above, agency theory seeks to understand how directors & officers are motivated towards decision-making, having considered their interests versus the interests of the shareholders and company itself. If their motivations are not in line, it can create decision-making processes that mark a strong divide between what is best for them and what is best for the company. Ultimately you want to incentivize the decision-makers to make choices that best reflect the needs of the company.

The legal landscape that speaks to this concept is fairly trite law in Canada and undisputed. However, instead of having an eye towards positive reinforcement, the law simply prescribes a fiduciary obligation on the officers to act in the best interest of the company. It is a negatively reinforced obligation. Therefore, if one could prove that the acquisition was done only in order to secure a stock option bonus for example, but would negatively affect the acquiring company, the director could be found liable for breach of obligations to the corporation.

In Canada, all directors and officers have two basic duties towards the corporation; Fiduciary duty, and Duty of Care. Pursuant to the *Ontario Business Corporations Act*, section 134(1):

> "Every director and officer of a corporation in exercising his or her powers and discharging his or her duties to the corporation shall,
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"

The *Canadian Business Corporations Act* has similar language. What does this mean practically speaking? According to *Peoples Department Stores v Wise,* it means that D&O must act honestly and in good faith specifically towards the corporation, i.e., the entity itself. This is slightly different than the American purview of acting towards increasing shareholder value purely. It includes obligations such as avoiding conflicts of interests, maintaining confidentiality of information, serving the corporation selflessly, honestly, and loyally, but most importantly not abusing their positions for personal benefit.

*BCE Inc. v 1976 Debentureholders* reinforced this notion by explaining that the duty owed is specifically to the corporation and generally focused on long-term interests. Additionally, boards should turn their minds to different stakeholder groups but

ultimately be granted deference by way of the "business judgment rule" an admission by the courts that perhaps the officers know how to run their company better than a judge.

Additionally under 134(1)(b), there is a Duty of Care whereby the courts will look to see if the decision maker was reasonable and not necessarily perfect. The court does not have the right to substitute its own opinion of what the decision should have been. Put another way, as analogous to Administrative law, the test is that of reasonableness and not correctness.

Having considered all the legal obligations above, we can begin to imagine how basic motivation principles such as pay for performance can impact decision-making to the point of creating a conflict of interest, or enticing directors and officers to act in their best interest over the legal obligation of acting towards the interests of the corporation, having considered the corporation's stakeholders.

*Socio-Psychological Frameworks that Drive Agency Issues*

On one hand, M&A can provide quick and drastically high returns for companies that the executives work for. On the other, they are mandated by law to only take risks related to high-return M&A when it is in the best interest of the corporation. Therefore, the corporation creates incentives to drive up acquisitions in the hopes that those incentives don't cause that behavior regardless of its positive or negative outcome. Yet executives are also at least in part self-interested. This leads us to issues of agency theory as well as the behavioural psychology aspect of incentivization with competing interests.

One study by Jeongil Seo set out to ask the question: "Under what conditions will the compensation package trigger CEO self-serving behaviours?" The study combines equity theory and agency theory in the following way: equity theory seeks to course correct one's behavior using an analysis of their input over their output as compared to others in similar positions. Then, if they feel as though they are working too hard for what they get, or working too little for what they get, as compared to others, they will course correct their behavior. This is done by either working less so it corresponds to your compensation, working more if you feel your not doing enough for your compensation, or seeking another opportunity where the input and output are on par with your peers and outcome expectations. In the context of this study with respect to M&A activity, the author wants to determine if CEO's who feel they are underpaid want to offset this discrepancy through more aggressive M&A and correspondingly more direct say in the Board's decision making process or conversely whether they are more likely to leave the firm altogether, which is done by spending more time on their social equity to increase their employability. The author found that when externally paid CEO's were underpaid, they attempted to restore that pay discrepancy by influencing their board's compensation decision process, which resulted in pay increases. This same demographic also tended to engage in more acquisitions in an effort to increase firm size. Internally paid CEO's were more likely to engage in acquisitions and diversification activities. Internally paid CEO's expect increases in pay relative to firm size. They did not, in contrast, try to interfere with board activities. This is explained by the other as behaviours that are dictated by the CEO's relationship to their peers. Internally paid CEO's want to maintain equity between themselves and their top managers and have more of a

relationship based decision making structure, versus externally paid CEO's who can act in a more self-interested manner as the factors driving equity theory are low due to the lower relational proximity to the rest of management as comparators. The CEO, if paid internally will want to avoid lowering motivation of their internal managers fearing a reduction in performance output. The study exemplifies the power of external impressions driving one's behavior and how perceived equity can dictate how deserving one is for increased compensation forcing them to take on more activities like acquisitions that can quickly fill the perceived inequity gap. This is essential to disproving the idea that M&A activity is not only driven by personal profit maximization.

The fact of the matter is, executive pay has been increasing faster than firm profitability (Rundell, 1995). One could reasonably conclude then that basic pay for performance behavioral paradigms don't work all that well. When we see executives take on more aggressive stances towards acquisitions then, it begs the question of whether the CEO is taking on that risk for themselves or predominantly for shareholder wealth maximization.

*Effects of Executive Compensation on Mergers and Acquisitions*

As noted earlier, Mergers & Acquisitions – or Amalgamations, as is their legal reference in Canada – are primary growth strategies when time is of the greatest concern. They are the fastest way to gain market share, vertical integration capabilities, and most importantly a quick way to acquire shareholder value. In order to create and foster an environment conducive to acquisition, the board has to incentivize management to take

on these risky business decisions. The primary way this is done is through their executive compensation. A 1997 article entitled, *Mergers and Acquisitions: How Executive Compensation May affect a Deal* is a fitting introduction into how the two intertwine. The author notes why companies merge or acquire to begin with. First and foremost, competitive pressure causes companies to seek quick solutions through combining resources. These pressures compel companies to consolidate costs and pool resources, which will increase efficiency and profit. The author also notes reasons such as product or geographic diversification.

Unfortunately due to various motivational theories such as agency theory, there is a known paradox between the priorities of the executive decision makers and the shareholders. This has a potentially drastic effect on the corporation. A thesis completed at Cornell on CEO compensation and incentives concluded that executive compensation, specifically their bonuses, was most correlated with their own power to influence the board of directors. While this increase in bonuses did positively correlate with their effort to create valuable amalgamations, there was no significant correlation between bonuses and deal performance.

Put simply by Amal and Said (2003) in their dissertation entitled *The Dynamic Relation Between CEO's Compensation and Earnings Management*, "Incentives and opportunities induce managers to manipulate earnings." Their study examines how earnings management simultaneously interacts with the level and structure of managers' compensation. It is a fitting start to the discussion because they lay a groundwork of sorts with respect to the notion that compensation mixes will affect performance. To that effect they put forward several points. First, management earnings is attenuated by the total

compensation mix beyond their base salary, this includes bonuses and stock-based compensation. Second they look at the structure as an attenuating factor, such as whether the stock is given outright or through the use of options. Third, they look at whether the compensation mix contributes to effects of income smoothing and lastly, they look at the relationship overall. These distinctions seem intuitive at first but are necessary for those wanting to understand basic motivation theory and are not informed about the various levels of compensation mix. They also are the premises that allow further studies to work off of such as how M&A activity might differ given a change in any of these foundational premises. The results of their study showed strong evidence that CEO's have incentives to manage earnings thus increasing their total compensation and maximizing their pay for performance compensation categories such as bonuses and stock-options. Therefore, before any M&A activity is undertaken at all, executives are inclined to manipulate corporate performance in the interest of receiving higher financial incentives. This is just the beginning of how management decisions will be undertaken in the interest of personal gain.

In 2008, a series of authors from the University of Houston collaborated on a meta-analysis of these very relationships to summarize past literature on the topic (Williams, Michael and Waller, 2008). Fittingly, they set out to review managerial incentives, merger activity, performance, and the use of compensation to mitigate agency problems. The first thing they found, rather intuitively, is that there is a strong relationship between pay and performance, but more so when all forms of compensation were included. This is intuitive because any ancillary forms of compensation including 'non-equity' based compensation, in addition to one's base salary, and from a

behavioural perspective, is known to enhance performance. Where the study becomes more informative is with respect to the behavior of executive officers with respect to M&A Aggressiveness. The study notes a 2004 article that asserts that because of the tremendous bargaining power of CEO's, they could very well end up negotiating deals that are better for their personal portfolios than for the shareholders. They note that Target company CEOs end up with ten to sixteen times their premerger cash compensation and find that a large amount of CEO's who exit the firm remain unemployed following the merger. These results seem to indicate that there is more incentive to cash out with a high profile merger that does not guarantee job security or employment, rather than avoid the opportunity to make a safer decision on behalf of the corporation.

More recently, in 2013, Becher & Juergens broached the topic in a paper entitled, *Do Acquirer CEO Incentives Impact Mergers?* They argue that the wealth of a CEO prior to engaging in a merger will impact their risk tolerance and ultimately their willingness to undertake a merger. They note that when the structure of the CEO compensation mix includes more risky types of compensation such as options, the company they belong to will "likely become an acquirer, pay higher premiums, and experience lower post-merger performance". This article had an interesting impact on how we view incentives. While traditional models would dictate wealth tied to performance and therefore risk, as the cause of risk avoidance behavior, it can actually do the opposite if the risk is linked to option wealth. This is significant because, as they note, while CEOs cannot impact how the deal will perform after the fact, they have a high degree of influence on completion and performance during the deal.

This is in contrast to a study by Grinstein and Hribar in 2003 that looked at behaviours of the acquiring firm managers and executives. They claim that managerial power is a primary determinant of bonus compensation. They found that the bonuses directly related to the size of the merger, the length of time needed to finish the deal and the number of board meetings during the year of acquisition. Additionally, in support of certain CEO duality concerns, they found that the power managers had over their board were more significant than effort and skill, two variables that the authors claim are not reliable factors to explain bonus variation amongst the executive samples.

Bliss and Rosen (2001) in the same study found that managers actually benefit from mergers that are more likely to harm shareholders. While boards seemed to have rewarded managers and executives based purely on growth, there was no enquiry as to the source of the growth, and so despite other indicators such as declining share price, the CEOs continued to be compensated on generic and ambiguous growth measures. The positive lining of the article was that it confirmed the notion that managers are less likely to engage in acquisitions where they are compensated with equity versus cash. It reinforces the idea that forcing the executive to have a financial interest in their decision can align their interests with shareholders. This may align interests not only by way of personal investment but also with respect to risk aversion theory. The authors note that CEOs who engage in a high level of M&A activity are not being aggressive but rather are spreading their risk amongst many corporations through the use of equity-based compensation post-merger. Despite their demeanor, it is still a largely personal-driven decision making process, without consideration towards shareholders, unless that risk translates to the corporation as well. Presumably it would. Perhaps this is one scenario in

opposition of agency theory issues towards a more integrative interpretation of aggressive M&A activity.

An article in 2009 by Fung, Jo & Tsai, looked at the various explanations behind the agency problems that lead to irrational market-driven acquisitions. They set out to examine the different ways in which stock market valuation and managerial incentives jointly affect M&A activity. They also looked at post-M&A performance to enhance their study. They found that market valuation had a significant effect on acquisition decisions, more so where executive compensation included less managerial equity ownership, more stock options, and no long-term incentive plans. They note that these acquisitions are likely to be financed using the firm's stock along with a high premium and done when the market valued the equity higher than usual. While the management compensation mix represents a certain profile that engaged in this kind of activity, partaking in acquisitions during peak valuations should not always translate automatically into a self-serving determination. The same can also be said with respect to using the companies own stock to finance acquisitions. What can be said is that when these are done without a long-term orientation, and in conjunction with the particular compensation mix, they tend to lead to a decrease in the corporations value. Under these circumstances then the authors give several reasons for this behavior such as self-interest, managerial myopia, overconfidence, misaligned incentives, empire-building motives and poor corporate governance. The article quotes quite an apt description of the views of the executive on M&A activity. They cite an example from *The New York Times,* commenting on a famous Merger of AOL and Time Warner in 2000, which became famous for destroying firm value:

> "To most investors, mergers are the stock market's equivalent of catnip…and yet, for all the profit and promise that mergers seem to hold, the truth about companies combining their operations is a darker one. Academic research suggests that few mergers add up to significantly more prosperous or successful companies and also that acquisitions during buyout booms, like the one we are in now, are more likely to fail than those made in other periods. And when one company acquires another using its own stock as currency, as commonly happens today, shareholders' stakes in the acquiring firm typically decline. What's worse, there is a disturbing trend among some of the most aggressive corporate acquirers to use deals to mask deteriorating financial results at their companies and to reap outsize executive pay."

Other studies show that the cash compensation after a merger is a reflection of the companies expected post-merger operating profit. This would support the more calculated approach to a compensation committee decision making while simultaneously aligning the interests to some post-merger metric of the target company.

Other times, a board of directors wants to encourage a normally conservative CEO to engage in more risky behavior. Rosen (2005) notes that if the directors already pay their executives well, they are more likely to make acquisitions in the future and that these inflated compensation packages encourage merger activity in the first place. This challenges the assumption that CEOs are presumed to have the more aggressive stance towards this type of expatiated growth.

Another paper that looked at M&A activity, specifically from a corporate governance perspective saw tenure and risk play an interacting role. They note that generally, corporations with high acquisition activity have younger CEOs with lower tenure and are more agreeable to risk taking. This notion is consistent with other studies finding CEOs with higher tenure to be more risk averse as a result of their comfortable compensation scheme where they have more to lose if they take on uncertain activities. The study also found that for the acquisitions that gave large returns, the boards for these acquiring firms had a high degree of independence and operating efficiency. They also have "higher managerial ownership and compensations of their CEOs have high bonus incentives and low options incentives." As well, they therefore have a higher fraction of the cost of poor decisions. Unlike the other studies, this paper cites a strengthening of corporate governance procedures post-acquisition, a silver lining in many of the unsuccessful acquisition activity.

A study in 2015 by Bedwell et al., looked at CFO compensation during Acquisitions years. They found that the CFO's compensation was higher overall during acquisition years as compared to all other CFO's in the sample, where equity incentives made up a larger portion of their compensation mix. The compensation increased as the acquisition deal size increased and completion dates shortened. They also noted that CFO compensation mix was not tied to short-term share prices.

A U.S. based study conducted between 1993-2006 found that CEO's of firms with at least one successful deal in a given year earned 5.1% (roughly $270,300) more than CEOs in similar firms with no M&A activity. Further, "raising the annual deal value relative to assets by 1$ increases the total CEO pay by about 23%" (Kumar, Kuo, &

Ramchand, 2012). The article, in addition to their findings on the positive relationship between M&A on compensation, note that the more entrenched the CEO, the less likely to be effective at leveraging M&A success for increased compensation. They explain this as a byproduct of more established CEO's being driven by non-performance based compensation. Given their tenure and influence they are more interested in maintain the status quo than pursuing more risky performance initiatives. Lastly, and most importantly, the article's main conclusion is that CEO's will try and leverage recent strong firm stock activity to drive M&A activity, which in turn, positively impacts CEO compensation. This is an interesting insight, as CEO's may then put the corporations high performance streak at risk by leveraging it for M&A activity whether truly justified or not, in the interest of increasing their compensation. This is one very strong example of the issue inherent in agency theory and executive compensation being influenced by M&A.

Marsh et. Al., look at how CEO's exercise their stock options after the acquisition closes. They observed executives engaging in especially risky acquisitions with increasing frequency, which in most cases have not created increases in shareholder wealth and in some cases, decrease shareholder value. They also use agency theory and overconfidence theory to look at how motivations change with respect to making an acquisition decision as compared to following through once the decision is made. Put simply, "Directors should be wary of overly optimistic CEO's when making the decision to acquire, however, they should be more wary of the firm being exploited for personal gain once the decision to acquire has been made." Thus the emphasis shifts from overly confident CEO's to concerns of agency theory and split interests once the acquisition has

been set in motion. This is a particularly important insight with respect to how boards and compensation committee's craft their executive compensation schemes for acquisitions.

Broadly speaking, forms of Equity-Based Compensation (EBC) has shown to provide more prudent investing by the officers and directors of a company. A study in the Journal of Finance entitled "Executive Compensation and Corporate Acquisition Decisions" by Datta, Iskander & Kartik Raman, show that as a result of equity based compensation during the stock option compensation boom in the 1990's they were able to show that EBC could lower acquisition premiums and increase the acquisition of companies with large growth opportunities. This study used long terms measures (-200 days/+3 years) to monitor the share price before and after acquisition announcements. One of the reasons for this is to account for real value growth versus speculation fluctuation during acquisitions. This is in stark contrast to a thesis by Andre Bickel, which took advantage of abnormal returns during acquisitions announcements to measure executive compensation levels. Over a period of nine years between 2006 and 2014, Bickel measured cumulative abnormal returns on the day prior and day immediately after acquisition announcements and found that negative abnormal returns were positively correlated with bonuses and cash compensation, highlighting the issues of the agency relationship.

Measuring impact around the acquisition announcement date may also have an effect on perceived value of acquisitions by shareholders. Ruiz & Renneboog observed in 2013 whether CEO EBC's influence acquiring shareholder value around the time of the announcement. They found that shareholders generally value acquisitions more where the EBC is higher. However, where a large shareholder has a higher percentage ownership in

the company, they viewed the value lower if the EBC was higher. Further, they found that excessive compensation negatively influences the acquiring shareholder valuation. The authors emphasized the relationship between ownership and EBC to the extent it impacts shareholder perception of value paid for executives and the perceived value of the acquisitions themselves.

Not all compensation models are built to incentivize CEO's equally. A dissertation written by Bunyamin Onal at Georgia State University found evidence that Boards will create customized incentive plans based on the *type* of acquisition, moving from stock option to bonuses depending on the economic risk of the acquisition itself. He notes that the, "greater economic uncertainties that are likely to follow conglomerate acquisitions induce the board to rely more heavily on stock-based incentives, an external monitoring system. This is a rather optimistic finding in that it presumes the board to not only be conscience of compensation affects but actually use it to their advantage to motivate CEO's based on external conditions and market performance. This takes away some of the decision-making power derived from incentivization schemes of the CEO's themselves. It also guarantees decisions that will at least try to secure future long term performance. Thus even if motivated by compensation increase to drive acquisitions, it would have a positive affect on corporate performance creating a win-win for both the executive officers and the corporation.

This is an apt analysis given that the different types of compensation are associated with different behaviors such as risk aversion. Depending on the aggressiveness of the board, a company might be able to direct acquisition quantity, irrespective of quality, depending on how they pay the CEO. A study by Gerard Sanders

looks at the behavioral responses of CEO's depending on whether they are paid by way of stock ownership versus stock options. He notes that most people mistake these two compensation types as being aligned in terms of motivational incentive. However, he claims that they are in actuality incongruent due to their "asymmetrical risk properties". CEO's will then respond to these offerings in different ways. He concludes that these two compensation schemes had "diametrically opposite effects on firms' acquisition and divestiture propensity" and that "situational characteristics moderated the risk-seeking behavior associated with stock option pay but not risk aversion associated with ownership". Ultimately, these findings confirm that upper management is not immune to these personal financial incentives increasing overall risk of decision making as it effects corporate and shareholder interest.

Another study that looks at customizing compensation based on performance seeks to understand how CEO compensation is protected against expenses post-acquisition. Entitled, *The Shielding of CEO Cash Compensation From Post-acquisition Earnings' Charges,* the study looks at whether CEO compensation is protected against negative effects of restructuring costs and asset impairments following the acquisition of the controlling interest in the stock or another corporation. The study suggests that the compensation committee places more weight on restructuring following an acquisition than on earnings when determining CEO cash compensation. They will increase CEO compensation to promote restructuring activities. CEO's even reported compensation increases even when the acquisition company reported a loss in its post-acquisition performance. This direction towards restructuring promotion has been supported by other studies as well. In a Dissertation at Pennsylvania State University, Anahit Mkrtchyan

notes that there is some evidence to suggest that firms with higher equity-based compensation experience better post-acquisition operating performance. Without asserting a causation relationship, there is some correlation with respect to the emphasis on restructuring and operating performance, despite potential short term losses.

Additionally, the article finds that CEO compensation is not negatively effected when the company experiences goodwill impairments as a result of the acquisition, and is completely shielded from negative effect if the acquiring company overpays for the target firm. The author interprets these findings to mean that, "compensation committees place greater emphasis on obtaining future synergistic gains from merger transactions despite current year losses. While this study looks only at cash-based compensation, it allocates a fair bit of agency on the Board of directors to use compensation to address their organizational objectives. This study supports the notion that the board, along with the compensation committee, is a lot more in control of the incentive structure based on the needs of the acquisition, versus the implication that CEO's can manipulate their compensations structure to serve their needs through acquisition quantity. This notion is not a new one. It has been a longstanding topic of interest for many finance academics. A study done in 1990 looked at post-acquisition financial performance and executive compensation also with respect to cash based compensation. While the results are similar, they noted that the increase relative to the acquisition in most cases of their sample, roughly corresponded to the added responsibilities of the executive management, thus justifying the increase.

Up until this point, we have discussed scenarios where the board of directors influences CEO compensation to drive acquisitions which could either positively or

negatively affect the long term value of the corporation. However, there are instances where the CEO themselves also hold a position on the board of directors. This causes an even more suspicious scenario of how CEO and executive compensation is created. This is known as CEO duality. CEO duality refers to a situation where the CEO also holds the position of the chairman of the board. However, since the board of directors is set up to monitor, hire and fire executive management and create their compensation schemes, a conflict of interest could arise depending on the amount of control that CEO has on the rest of the board. Its initially conceived purpose was altruistic. The corporation could create better value if the executive team was unified with the ideals, values and direction of the board. However, this control comes with the potential for shareholders to have a difficult time of disciplining or removing the CEO.

One particular study set out to find out if this CEO duality affects compensation with respect to M&A activity. The article by Dorata and Petra (2008) sought to examine whether CEO duality further exacerbates CEO's motivation of self-interest to engage in mergers and acquisitions to increase their compensation. In their findings they discover that for merging firms CEO compensation is positively associated with firm size, but the association is not moderated by CEO duality. Conversely for non-merging firms, CEO compensation is positively associated with firm size and firm performance. In fact, it was a moderator between firm size and performance. In other words, CEO duality has an effect on their compensation increase, which is not driven as much by performance based standards. This is in contrast to the high-risk M&A-activity firms where CEO's are rewarded for their high-risk behavior. The study recommends that shareholders should support the separation of Board chair and CEO in order to keep compensation levels

positively associated with firm performance. Despite similar governance structure and firm performance, CEO's of merging firms command higher compensation.

In addition to the relationship between the variables as they pertain to M&A activity more generally, there were those who sought to leverage particularly difficult economic times to see if this relationship might be affected. The most opportune event recently to conduct such a study was with respect to the 2008 financial crisis, where corporate activity had a direct link to individual greed and behavioural theories. Clinton Robert Satyavelu, at the University of Phoenix, wanted to see if the relationship between compensation and corporate performance would change in the context of economic hardship during the 2008 government bailout. The study looked at annual compensation and end-of-fiscal-year financial share price of Fortune 500 financial industry stock performance over a five year period leading up to the bailout. Interestingly, the study revealed a non-significant relationship between executive compensation and share price. However, the author did recommend a qualitative assessment that compensation committee's can use to benchmark comparative companies against theirs to determine the best mix of executive compensation. The author further claims that this benchmarking system would provide a strong defense against government and shareholder activist initiatives to enforce compensation restrictions. There is a rather pronounced convenience to showing no relationship right after the crisis, when we have other studies that highlight the sophistication of directors and compensation committee's to direct the type of compensation mix to a desired goal.

# CHAPTER 4
# DISCUSSION

When viewed altogether, the studies show several interesting insights into the world of behavioural modification related to corporate decision making. They begin by outlining some of the complexities that arise out of choosing the right type of compensation. This is seen for example where the difference of a bonus or an option in the acquiring firm can change the CEO's risk profile because he may then have 'skin in the game'. They continue by discussing the measures of firm performance and how that may or may not accurately reflect what they are trying to accomplish, or even accurately reflect the actual performance of the firm because they account for abnormal returns. Traditionally, one would think that generally there is a positive correlation between pay and performance. All of these insights led however, led to a more complex picture.

*The first insight to be addressed is the very opposite of the traditional view; Pay for performance can negatively impact director & officer decisions to engage in M&A.* While it seems counterintuitive, this is the findings of many studies that reinforce and give life to agency theory issues. For example, CEO's with higher tenure and more established compensation structures were reluctant to take on a more risky decision style. The more they got paid and the longer they were there, the more it seemed they wanted to maintain the status quo. Another study showed this by proving that CEO's are largely self-interested. When paid for M&A Activity, they will be more inclined to push deals through while the long term performance, or post-merger performance, suffers. This was

even more prevalent in cases of CEO duality where they have more influence as they reside in both executive management and the board of directors.

*The second insight is that executive officers are not only guided by compensation maximization*. Studies show this, as explained above, with older more established CEO's who don't seek to maximize pay for performance options where they are already getting compensated well for their tenure. One could argue that the risk averse strategy, in their mind, is maximizing profit, as the pay for performance is too high of a risk, but the research pointed to risk avoidance and comfort as the prime reasons for this preference.

*The third insight I noticed was that there is a difference between tying compensation to perceived shareholder satisfaction and actual value creation for the corporation.* This insight was one of the more interesting ones this paper has come across. One of the most used measures of corporate return was shareholder value. What surfaced very quickly was a notion that this is not such a clear-cut exercise. Even if the study ignored institutional trading and accredited investor activity, there is a looming question of when a researcher ought to measure the market capitalization value in relation to the acquisition itself. One study found that they were able to capture abnormal returns by measuring the day before and the day after the announcement date of the acquisition. If we parallel this to studies about CEO's making acquisitions for short term gains in order to get a pay day, the abnormal returns should be high, in addition to taking advantage of certain peak market times. However these abnormal times are largely

illusory and thus, while they can inform us about the dangers of agency theory, do not actually give a fair indicator as to how the company is performing as a real result of the activity. One study combatted this by measuring performance of certain measure like book to market ratio and market capitalization over various intervals such as 60 days 200 days and year to date. This gave a more accurate picture of the firm performance, but it, like others, showed a decline in firm performance in the long term, post-merger or acquisition.

*The fourth insight is that the board of directors and the compensation committees are actually significantly more sophisticated with respect to crafting schemes that target specific behaviours.* This has deep ramifications for issues of agency theory. This is because the intent of the executive officers don't matter as much if their interests, no matter how selfish, are not only in line with the company, but actually provoked intentionally by the committee and directors that pay them. Agency theory becomes an issue when CEO's are acting in their self-interest and it conflicts with that of the corporation. However, if the corporation is eliciting those behaviours by trying to create a compensation scheme that targets more risk taking, it would be hard to blame the CEO's for this activity. This was especially true with boards hiring younger CEO's because they had a more risky attitude towards M&A. Compensation committees became even more savvy when they began giving CEO's option based pay instead of bonuses intentionally to keep CEO's invested in their decisions. This is highly sophisticated, as the traditional view of agency theory presumes misaligned objectives due to traditional compensation schemes.

*The fifth insight is that directors and officers will not only make financial decisions that actually impact a company based on their compensation, but will also engage in management practices such as earnings management to fictitiously inflate company health when faced with potentially higher compensation as a result.* This insight seems surprising at first, but then seems fitting given the other articles about post-merger performance and measuring abnormal returns. Along with inflated market prices, and managerial influence to push a deal through, some executives have resorted to earnings management in order to achieve financially appealing statistics that favour M&A activity. This is perhaps another jarring tool in their tool belt to romanticize M&A decisions. This insight becomes particularly concerning in situations of CEO duality when they have even more control over the board as well as the executive and exert influence to advance these changes.

# CHAPTER 5
# CONCLUSION

As noted above, the world of M&A activity and executive compensation is a very complex one. CEO's are motivated by any number of things depending on their personal characteristics, and these entities are so sophisticated that it makes one wonder whether CEO's can be blamed at all for their behaviours if directors are so willing and able to manipulate them through the use of compensation. Moreover, agency theory would suggest that there are issues derived from misaligned goals, but if the goals are aligned due to this compensation rigging, then they can align goals even if the underlying motive of management is selfish. After all corporations don't need altruistic management, just one's that are objectively aligned. The ends justify the means. I am not insinuating that executives are unsophisticated puppets that act only according to their boards, they too need to have an understanding of how they react to certain incentive schemes so they can combat their inclinations to make shortsighted decisions. Moreover, a note can be taken again from the Swiss watch industry. In the past ten years or so, export sales of Swiss watches have been highly depressed. This is due to a number of reasons such as the Swiss franc inflation and a post-recession frugalness. To combat these reduction in sales, Swiss watch companies began selling numerous "Limited Edition" models every year. The variety and amount of SKU's skyrocketed created interesting and rare one-off's that collectors would purchase at a premium. While the consumer base shrunk, the watch companies began squeezing any novelty they could for an immediate dollar, even if it hurt the firm's market value in the long run. They sacrificed long term value with immediate revenue. This is an apt parallel to the world of acquisitions. At the very

beginning of the paper, it was noted that acquisitions and mergers are the fastest way to grow in a market as compared to internal growth and has some immediate rewards. It is possible then, that just to stay afloat, companies are banking on high valuation cycles and quick gains to survive in the short term at the expense of long-term valuations. If this is the case, fault cannot be attributed to any one executive. The liability may fall on them all equally.

Looking back at the broader theme of corporate governance, we have to ask whose obligation is it anyway? If the directors and officers are so sophisticated, then despite their intelligent processes, could they be held liable for breaching their fiduciary duty if they knowingly egg on an executive's selfish streak in the hopes that the aggressive acquisition behavior benefits them in some way? Agency theory issues, in some ways, stemmed from a place of ignorance. Surely if directors knew that management was misaligned with them they would take efforts to correct it. Conversely, where the directors consciously affect behaviours, this would have drastic impacts on their duty of care and fiduciary obligation. Ultimately, all of these disciplines combine and interact with each other. The gamut of corporate governance grows wider each day, with more sophisticated players, which have a responsibility to understand the finer complexities of corporate action.

# CHAPTER 6
# LIMITATIONS AND DIRECTIONS FOR FUTURE RESEARCH

Amongst the many articles, studies and papers discussed in this paper, there are a few key themes that are common. The first is that this subject understandably became very popular after the 2008 financial crisis resulting in many studies around this time period. More research would likely uncover other notable dates that the publications revolve around. There is a very enticing relationship to explore when an entire country is blaming a specific group for self-serving behaviours related to financial gain. In fact, it was originally my intention to look at a period of data between 2010 and 2014 specifically for this reason, to see how this organizational behavior changed or remained the same in the period following the crisis. It is easy to find self serving relationships amidst the activity of the financial crisis. More research is needed to smooth out the results over years and decades to make more sound conclusions. It might even benefit us to find some qualitative moderating factor over those decades that can account for economic cycles in both society and business. The second key theme is that many of these papers are working papers. I need not delve into the concerns related to a lack of peer review processes. Although despite that I think they have contributed to the summary of knowledge by exploring novel relationships and new ways of attacking a common problem, i.e. the paradox of conflicting motives.

Having briefly discussed certain observations that may limit the research, there are ample new topics to be researched and studied up on. In my review, there were three main areas of research I wanted to examine in more depth.

The first is the relationship of geography and cross-cultural management with respect to executive compensation and M&A activity. This is, in my mind, the most important area for further enquiry in the literature. We are fortunate to now have financial exchanges in some of the most diverse areas and cultures around the globe. With each culture comes a unique cultural dimension – relating to traditional theories of Hofstede and Trompenaar – and with each cultural dimension comes a new way of thinking about how human beings are motivated, their philosophy of work, and how they make decisions in the interest of the corporation they work for. Even a simple concept such as low power distance and uncertainty avoidance can have drastic effects on how executives make acquisition decisions.

The second area of study is that of industry differences amongst M&A activity. Research is readily available with respect to the frequency of acquisitions in each industry. Some industries, such as real estate have a much higher rate of acquisitions than others such as consumer staples. This is due, in part, to the unique characteristics of each market. For example, technology has a rather large growth rate and as a result they go through much shorter business cycles than energy for example. This creates many more opportunities for acquisitions with new companies and products surfacing every month. In Figure 1 below, we can see a basic distribution of acquisition activity of Russell 3000 companies between 2010 and 2014.

**Figure 1**

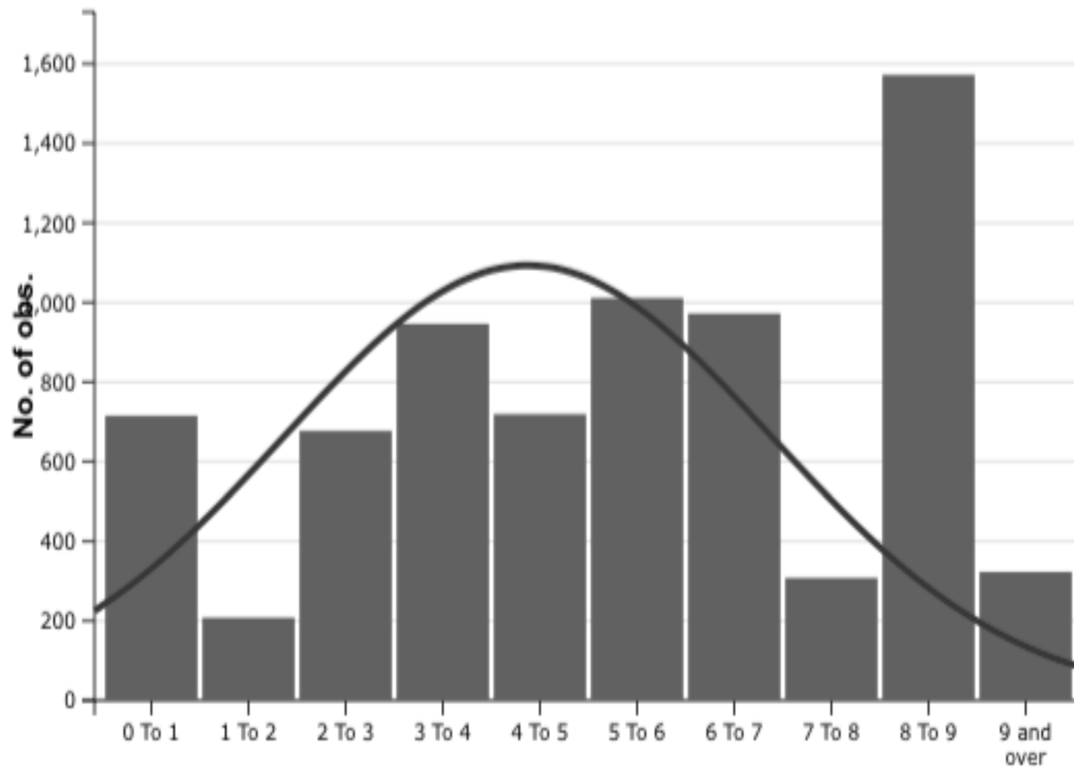


**Table 1**

| | INDUSTRY |
|---|---|
| **0-1** | Consumer Discretionary |
| **1-2** | Consumer Staples |
| **2-3** | Energy |
| **3-4** | Financials |
| **4-5** | Health Care |
| **5-6** | Industrials |
| **6-7** | Information Technology |
| **7-8** | Materials |
| **8-9** | Real Estate |
| **9 and Over** | Telecommunication Services & Utilities |

There is quite a lot to be discovered if the studies focused on the differences of acquisition activity based on industry. Aside from looking at how the industries operate, it can help inform us about the behavioral conditioning of CEOs who come from particular industries. Directors could better design the compensation mix to offset any behavioural habits the industry worked into the CEO's mindset. Directors could also focus on poaching executives that come from an industry that has a more desirable mindset towards the particular objectives of the corporation.

Lastly, there is an area of research that can be done with respect to the CEOs themselves, regardless of the intentions, objectives and behaviours of the directors to achieve certain organizational goals. There is ample information now on Bloomberg that can report on CEO tenure, age, work history, and frequency of acquisitions during tenure. These statistics can greatly contribute to the knowledge base about the habits of CEOs. As noted above in the literature, there is something to be said about how longer tenured CEOs prefer to avoid risk so as to maintain there current lifestyle. This is in contrast to younger CEOs who have more to prove with less on the line, who are more willing to take on more aggressive growth strategies. Compensation committees and boards can use this information to target specific behaviours. This will greatly reduce issues in agency theory as you are pulling individuals who, while their dispositions are largely selfish, will align nicely with the organizational goals. The alternative is a mismatch of goals that leads to agency issues.

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