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Publication status and date:
Published: 01/01/2014

Document Version
Publisher's PDF, also known as Version of record

Citation for the published version (APA):
Qiu, B. (2014). Do CEOs trade premiums for personal gain in M&As? *RSM Discovery - Management Knowledge*, *20*(4), 8-9.
http://hdl.handle.net/1765/77373

Link to publication on the EUR Research Information Portal

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Do CEOs trade premiums for personal gain in M&As?

By **Buhui Qiu**

Chief executive officers are not to be fully trusted. At least, says a new study, chief executive officers at companies on the receiving end of a planned merger and acquisition transaction are not to be fully trusted.

This is one of the intriguing suggestions to emerge from the in-depth research undertaken that resulted in *Do target CEOs trade premiums for personal benefits?*, the paper I co-wrote with Svetoslav Trapkov of United Bulgarian Bank and Fadi Yakoub of Rabobank, which was published in Elsevier's *Journal of Banking & Finance* in early 2014.

The short headline answer to what some people might think is a provocative question is, quite simply, yes. A resounding yes. If our analysis of 2,198 completed US M&A transactions between 1994 and 2010 is correct, CEOs leading a target company will often be tempted to encourage acceptance of a bid that falls short of delivering full value to shareholders in return for the assurance of continued employment with the post-merger entity or an increased personal severance package.

In an era when the notions of commercial transparency and corporate governance requiring levels of disclosure unparalleled in joint stock company history have been elevated to almost sacred status, it is frankly little short of astonishing that such an anomaly should persist. If shareholders are not already picketing regulators to address the issue, they should begin doing so immediately. Conscientious regulators would surely not wait for such an external stimulus.

Conflict of interest

The conflict of interest in such a situation is self-evident. Senior managers have an undisputed fiduciary duty (inter alia) to deliver maximum value to shareholders in their company. In cases where a bid is made for that company, their prime concern should be to ensure that either the premium paid by the would-be buyer is maximised, or that the company delivers increased value by warding off the predator and improving its business performance.

However, even the most stony-faced CEO remains a human being; and human beings who have been unexpectedly threatened with the potential loss of their jobs, their status and their power, in the event that an acquisition proceeds, will almost instinctively put their own selfish personal interests first and foremost. Anecdotal evidence exists in abundance that proves this contention; unfortunately the possibility of provoking legal action dictates against naming names in such a distinguished public forum.

In the takeover process, an incumbent CEO might well not be paying attention to maximising shareholder value, but instead manning her or his own personal lifeboat. Our research – arguably the most extensive research undertaken to date in this field – uncovers a significantly negative relation between target CEO retention and takeover premiums received by target shareholders.

Our calculations, using publicly available data, show that the retention of target CEOs is, on average, related to a 6-percentage-point reduction in the four-week takeover premium paid to target shareholders. Given the US$1.15 billion average market capitalisation of the target firms in our sample, this premium reduction translates into a sizable value loss of around US$70 million to the shareholders of an average size target.

Moreover, when the target CEO was not retained, we document a significantly negative relation between the relative importance of severance pay received by target CEOs and the takeover premium received by target shareholders. Our investigation of the joint effect of target CEO retention and CEO severance pay on takeover premiums further confirms both effects to be significantly negative.

Our calculations show that a 10-percentage-point increase in the relative importance of severance pay received by non-retained target CEOs is related to a 1.2-percentage-point reduction in the four-week takeover premium

received by target shareholders, which translates to a sizable value loss to the tune of US$13 million to shareholders of an average-size target in the non-retention subsample.

Personal gain

While some might argue that the figures are modest in both relative and absolute terms, the trend for CEOs to serve their own interests rather than those of their shareholders is clear: in certain circumstances, such as during corporate takeovers, they will tend to sacrifice shareholder value for personal gain. This is unacceptable behaviour for those entrusted with the temporary stewardship of a publicly listed company and steps must surely be taken to prevent it.

I detect at least two clear threats created by a situation in which current legislation and market practice do not necessarily require the publication of information relating to the retention of a CEO. One, if this information is hidden, it cannot form a part of the shareholder decision-making process and it could clearly increase the temptation for any CEO to indulge in a trade-off that benefits the CEO at the expense of shareholders.

Two, an acquiring firm could seek to acquire the target at a lower price by suggesting that the target CEO's nest be unduly feathered. Both will have the potential to damage shareholder value of the target firm.

There is no question in our mind that shareholders should demand full disclosure of all information related to the continued employment of incumbent senior management post-merger, or to their proposed severance packages.

There is equally no doubt that the information must be divulged. Dragging such information into the daylight is one way of ensuring that shareholders are not cheated out of what full value is rightfully theirs. Until this happens, we run the risk that personal greed will persist and continue to override management's fiduciary duty to shareholders.

Opponents of these findings will likely argue that coincidence does not necessarily mean cause and effect, and that the relationships we have identified is therefore spurious. But a few key points suggest otherwise. One, the size of our sample is unprecedented in the literature.

Two, controlling for a battery of CEO, target, deal, and acquirer characteristics commonly identified by the literature as affecting takeover premium and announcement returns, as well as for industry and year fixed effects, we continue to find significantly negative effects of target CEO retention and severance pay on takeover premium and target announcement stock returns.

Third, our findings continue to hold when we use managerial ability as an instrument for predicting target CEO retention, and employ a Heckman two-stage correction approach. Fourth, we find the negative relation between target CEO retention and takeover premium to be strengthened when the target CEO obtained a more important position in the merged entity, and the negative relation between target CEO severance pay and takeover premium to be strengthened when severance pay is negotiated during the takeover process rather than predefined in a CEO's golden parachute plan.

We are confident in our findings and conclude that while the current situation might be legal, it is certainly not ethical. ■

This article is based on the paper *Do target CEOs trade premiums for personal benefits?*, written by Buhui Qiu, Svetoslav Trapkov and Fadi Yakoub and published in the *Journal of Banking and Finance*, 42 (2014) 23-41. http://dx.doi.org/10.1016/j.jbankfin.2014.01.013

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