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Management turnover and executive compensation in synergistic takeovers

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Abstract

The purpose of this paper is to provide a model of management turnover and executive compensation for a synergistic takeover. I extend a principal-agent model to include a synergy factor. I argue that the choice of management structure—turnover or no-turnover—provides an opportunity for the shareholder to efficiently utilize three elements of the incentive contracts: effort, insurance (risk-reduction) and synergy.

I explain high turnover rates after takeovers, especially in conglomerate mergers as compared to horizontal mergers. Also, my model is consistent with empirical evidence that there is a high rate of management turnover in friendly as well as hostile takeovers and thus complements the model of the disciplinary role of takeovers. I also discuss an optimal compensation structure in synergistic takeovers compatible with their corresponding organizational forms. © 2001 Board of Trustees of the University of Illinois. All rights reserved.

Keywords: Synergistic takeover; Management turnover; Executive compensation

1. Introduction

High rates of management turnover after a takeover are well documented in literature. Martin and McConnell (1991) show that the turnovers of CEOs, chairpersons and presidents are about 56% and 29% in the first and the second year after a takeover during 1958–1984. Further, Morck, Shleifer and Vishny (1988) and Walsh (1988) provide additional evidence of a high rate of top management turnover after a takeover. A popular claim is that a takeover

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has the disciplinary power of an external market for corporate control. Thus, a takeover is often considered as a mechanism to replace inefficient top management teams.[1]

Although the disciplinary role of a takeover is often employed to explain high rates of management turnover, there are some weaknesses in the argument. First, an implicit assumption underlying the disciplinary aspect of a takeover is that the shareholders (or board of directors) are not capable of disciplining their own top managers. That is, it is implied that any internal governance structure (board of directors, proxy contests, compensation, etc.) in place may not work properly in target firms. If this is true, then the target management's nonvalue-maximizing behavior can be corrected by implementing a more efficient governance structure after a takeover. Therefore, this process does not necessarily lead to management turnover.

Shivdasani (1993) and Weisbach (1993) show evidence supporting the disciplinary role of corporate takeovers in examining the governance structure of *hostile* takeovers, which are believed to be disciplinary. However, they explain management turnovers only in the case of hostile takeovers, not *friendly* takeovers, which are considered to be synergistic. An interesting finding by Martin and McConnell (1991) is that the management turnover rate is no different in hostile and friendly takeovers. Further, they show that there is no difference between the pretakeover performances of hostile and friendly takeovers.

Second, it may not be true that the acquiring firm's managers are in the best position to determine the quality of target managers, especially when the acquiring firms are not in the same industry as the target firms (i.e., conglomerate mergers). However, Choi (1993a) suggests that the frequency of management turnover after a takeover is much higher in conglomerate mergers than in horizontal mergers.[2] Finally, there is a synergistic gain hypothesis that is well accepted for motivation of takeovers (See Bradley, Desai and Kim (1983)). The synergy hypothesis does not imply the replacement of target firm managers after mergers. Therefore, it is interesting to investigate a linkage between management turnover and synergy-driven takeovers.[3]

The purpose of the paper is to provide a model of management turnover and executive compensation for a synergy-motivated takeover. I extend a principal-agent model with a moral hazard problem (Holmstrom and Milgrom (1991)) to include a synergy factor. It is assumed that a takeover is motivated by potential synergy in resource allocation. Upon a takeover, the shareholders (represented by the board of directors) determine organizational structures and incentive contracts. Which is the more efficient organizational structure between two management groups after a takeover—the parent manager controlling both divisions (management turnover or centralized structure) or the parent and the subsidiary manager controlling their own divisions (no management turnover or decentralized structure)?[4] What is the optimal compensation structure under alternative organizational forms?

Ramakrishnan and Thakor (1991), Aron (1988) and Itoh (1992) also examine internal organization and overall efficiency. Although they use different terminology, they basically compare the two organizations considered in this paper. The main distinguishing feature in this paper is in considering synergies (production externalities) within organizations. Ramakrishnan and Thakor (1991) are interested in the principal's choice of cooperation and competition between two agents. A conglomerate merger is motivated by the shareholder's choice between incentive contracts with cooperating and competing managers. The corre-