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Managerial labor-market discipline and the characteristics of merger and acquisition transactions[☆]

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ABSTRACT

This study evaluates how state regulation of noncompetition agreements affects merger and acquisition activity. Noncompetition agreements put restrictions on postemployment activities, thereby reducing management mobility and forcing top managers to bear the long-term consequences of their corporate decisions. In this sense, state regulation of noncompetition agreements functions as a mechanism to align management's interests with those of the shareholders when management makes major corporate decisions. To examine this hypothesis empirically, this study tests whether the legal enforcement of noncompetition agreements across states affects the choice of payment methods, the premium paid for targets, and the acquirers' abnormal returns on their merger or acquisition activity. The results suggest that stricter enforcement of noncompetition agreements significantly reduces the likelihood of using stock in takeovers and the premiums paid for targets. In addition, the study documents that stronger enforcement of noncompetition agreements is related with more favorable market reactions for large acquirers.

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1. Introduction

Managers' interests diverge from investors' (Jensen and Meckling, 1976; Lloyd et al., 1987, among others). Corporate governance plays a significant role in promoting the efficient management of organization and therefore aligning managers' interests and investors'. Using various governance instruments, firms incorporate contracts, organizational structures (such as outside board monitoring, Desai et al., 2005), legislations, or other incentive mechanisms in order to reduce agency problems, align the interests of the corporate managers with those of the shareholders, and ensure the maximization of return on investment.

In recent years, it is increasingly common for corporations to use noncompetition agreements in their employment contracts to restrict certain aspects of postemployment activities. Noncompetition agreements, also known as covenants not to compete (CNCs), forbid employees from competing with their current employer either by working for rival companies or by starting similar businesses within a certain geographic region for a specified length of time (Whitmore, 1990). Although firms have been using noncompetition agreements as a means of protecting their investment in human capital and proprietary information (Rubin and Shedd, 1981), those agreements have also tended to generate another outcome that is to bind employees, especially key employees, to their current employer and substantially reduce their managerial mobility (Garmaise, 2005).

Given that the managerial labor market generally seeks executives with good records, poor decisions can have detrimental effect on the value of managers' human capital. While, this might suggest that the labor market can play a strong disciplinary role in forcing managers to care about the consequences of their investment decisions. Yet, since the actual implications of such decisions do not materialize instantly they may not be immediately incorporated in the managerial labor market. However, the presence of noncompetition agreements may alter such scenario. These agreements which bind managers to their companies and reduce their opportunities in the outside job market can in fact increase the likelihood for the market to observe the true consequences of managerial decisions—especially bad ones.

A recent study found evidence of negative consequences for bad managerial decision (Lehn and Zhao, 2006). According to the authors, managers who made acquisitions that resulted in negative market reaction had a higher probability of being fired in subsequent years. On the other hand, CEOs who were able to retain their positions for a longer period of time realized a positive outcome in the form of significant increase in salaries (Kroll et al., 1990). In terms of noncompetition agreements, since states have different enforcement levels, these findings suggest that managers in states with stricter enforcement have more incentive to be responsible for their decisions

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for a longer period of time. In the context of corporate takeovers, they are more likely to make value-enhancing acquisitions when they are forced to bear the long-term consequences of their decisions.

Therefore, since shareholders often use legal/regulatory system as a mechanism to resolve agency problem (Jensen, 1993), this paper argues that the strict enforcement of noncompetition agreements is a governance mechanism that shareholders can use to resolve agency problem. In essence, the resulting effect of noncompetition agreements in reducing managers' opportunities in the external labor market makes them a potent mechanism to align the interests of management with those of shareholders.

The variation in legal enforcement of noncompetition agreements in the U.S. provides a natural setting to test a series of decisions related to corporate finance activities. Focusing on merger and acquisition activities, the study will specifically analyze whether the level of enforcement will have an impact on management's choice of medium of exchange, the premium paid for targets, and the stock market's reaction to the announcements of merger and acquisition activities.

The study will proceed as follows. Section 2 provides a brief literature review. Section 3 introduces the data collection and sample construction. Section 4 presents the results. Section 5 discusses the limitations and implications for managers and future research.

2. Literature review

2.1. Noncompetition agreements

Human capital is a substantial part of the consequences of corporate investment (Schultz, 1961). Firms have long recognized it as a core asset and a significant contributor to productivity. Acquiring and maintaining such assets are particularly important in a world where sustained business success depends largely on innovation and tacit know-how.

A standard analysis of firm-specific human capital suggests that employers and employees share the cost and return on investment (Becker, 1962; Hashimoto, 1981). However, the inalienability of human capital (Hart and Moore, 1994) is generally a basic human right. Firms will experience potential loss if an employee terminates the labor contract at his/her will. Hence, unless they can exercise full ownership or control, firms would have less incentive to invest in human capital. As a consequence, they are more likely to restrict their employees' postemployment activities by incorporating noncompetition agreements in their contracts. From an economic perspective, these agreements can prevent net losses of investments in human capital, protect trade secrets and confidential information, and even function as a mechanism to select employees who are willing to enter into such contracts (Hertog, 2003).

2.2. Related research

2.2.1. Methods of payment

Following the rise in the number of mergers and acquisitions in the early 1980s numerous studies attempt to explain various aspects of merger and acquisition activities, such as motivation, long- and short-term performances, as well as payment methods. Relevant to the latter, studies find that the specific choice of payment (i.e. cash versus stock) does have an impact on the performance of merger and acquisition activities (Huang and Walking, 1987; Franks et al., 1988; Eckbo and Langhor, 1989). The majority of the established evidence reveals that cash financed transactions tend to have more favorable announcement effects than transactions using other exchange currencies (Travlos, 1987; Maloney et al., 1993; Moeller et al., 2004). Cash mergers or acquisitions were also associated with better post-merger or post-acquisition operating performance than stock financed acquisitions (Linn and Switzer, 2001).

The positive relationship between the all-cash payment method and the announcement effects is particularly true in taking over public targets (Moeller et al., 2004). Researches have offered various conjectures to explain the above relationship. For example, the free cash flow hypothesis suggested that even when the merging of two firms is not efficient, making an exclusive cash payment can create benefits by reducing managerial discretion and in turn agency costs (Jensen, 1986). The signaling hypothesis (Yook, 2003; Linn and Switzer, 2001) on the other hand suggests that the methods of payment convey signals about the quality of the project. It maintains that risk adverse managers will not use cash unless they are sure that the quality of the transaction justifies the personal risk of losing their jobs (Blazenko, 1987). Hence, from a shareholder perspective, an all-cash payment conveys positive signals about the management's confidence in the merger decision. Additionally, because they are clear and easy to establish, cash payments generate another positive outcome by reducing information asymmetry.

In essence, in both short-run and long-run, cash payment appears to benefit shareholders, especially when taking over public targets. Therefore, with regards to noncompetition agreements, and based on above arguments we contend that managers who are subject to stronger enforcement of such agreements would be more likely to pay cash for merger and acquisition activities as they would be responsible for their decisions for a longer period.

2.2.2. Bidder premium

A fundamental issue in organizations is guarding against managerial opportunism and self-interest behaviors. At the core of this issue is the agency problem resulting from a conflict of interests between the managers and the shareholders. In the context of mergers and acquisitions, the agency cost hypothesis (Jensen, 1986) proposes that managers make such decisions for reasons other than maximizing shareholders' value, such as building an empire to increase their compensation or social status. Evidence from previous studies shows that acquirers tend to pay higher premiums to complete the deals. In some cases, managers' self-serving objectives might motivate them to overpay targets in order to complete the deals (Morck et al., 1990). On the other hand, Kesner et al. (1994) and Porrini (2005), among others, examine the relationship between acquirers' financial advisors and premium paid. They find that to complete the deal and therefore to earn their advisory fees, investment banks have the incentives to convince their clients in paying higher premiums to the target. Furthermore, Hayward (2003) shows that it is those managers with the weakest corporate governance, in other words, highest agency problems, that are more likely to concur with their investment banks' advices. Overpayment can therefore represent a plausible interpretation of poor bidder performance.

Morck et al. (1990) however have also suggested that when making an acquisition decisions, in addition to their personal benefits, managers also consider consequences related to the market value of the acquiring firms. Therefore, due to the fact that noncompetition agreements reduce managers' mobility and increase the observing window of the consequences of their corporate decisions, we contend that, everything else equal, overpayment for targets would be less likely to occur when such managers who are subject to higher level of legal enforcement of these contractual agreements.

2.2.3. Stock market reaction

Existing research on takeovers suggests that on average acquiring firms experience insignificant or negative abnormal returns when they announce merger and acquisition activities. Such effect is especially evident when the targets are public companies and when acquirers use stocks to finance the deals (Fuller et al., 2002; Moeller et al., 2004). Citing agency theory and related managerial opportunism argument, some have hypothesized that the soaring number of merger and acquisition activities—even when gain is insignificant or