Journal of Financial Economics 103 (2012) 327–349

Contents lists available at SciVerse ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Board connections and M&A transactions ☆

Ye Cai [a,1], Merih Sevilir [b,*]

[a] Leavey School of Business, Santa Clara University, Santa Clara, CA 95053, United States
[b] Kelley School of Business, Indiana University, Bloomington, IN 47405, United States

ARTICLE INFO

Article history:
Received 27 April 2010
Received in revised form
2 February 2011
Accepted 6 May 2011
Available online 1 October 2011

JEL classification:
G34

Keywords:
Mergers and acquisitions
Acquirer returns
Board connections

ABSTRACT

We examine M&A transactions between firms with current board connections and find that acquirers obtain higher announcement returns in transactions with a first-degree connection where the acquirer and the target share a common director. Acquirer returns are also higher in transactions with a second-degree connection where one acquirer director and one target director serve on the same third board. Our results suggest that first-degree connections benefit acquirers with lower takeover premiums while second-degree connections benefit acquirers with greater value creation. Overall, we provide new evidence that board connectedness plays important roles in corporate investments and leads to greater value creation.

1. Introduction

This paper examines M&A transactions with a current board connection between acquirer and target firms and presents evidence that acquirers obtain significantly higher announcement returns in such transactions. We study two types of board connections between acquirer and target firms. The first type is where the two firms share a common director before the deal announcement and we refer to this type of connection as a "first-degree connection." The second type is where one director from the acquirer and one director from the target have been serving on the board of a third firm before the deal announcement. We refer to this type of connection as a "second-degree connection." We focus only on current board connections in that the acquirer and the target must have a board connection through their directors at the time of the deal announcement.

Having a board connection between two firms may improve information flow and communication between the firms, and increase each firm's knowledge and understanding of the other firm's operations and corporate culture. This enhanced knowledge and information advantage, in turn, may lead to a better M&A transaction between the two firms. The information advantage may also affect the takeover premium and hence the transaction price of the deal. This is because acquirers with a board connection to the target may enjoy a bargaining advantage in deal negotiations due to their private information about the target firm, relative to outside bidders with no connection to the target. In addition, particularly in first-degree connections, the presence of an acquirer's director on the target firm's board

☆ We thank an anonymous referee, Laurent Fresard, Paolo Fulghieri, Jay Hartzell, Fred Hood, Matthias Kahl, Paige Ouimet, David Ravenscraft, Anil Shivdasani, Gunter Strobl, Ed Van Wesep, and conference and seminar participants at the 2010 WFA conference, 2010 FMA conference, Fairfield University, FAU, HEC Paris, Imperial College, Indiana University, Miami University, Michigan State University, Northeastern University, Santa Clara University, University of Dayton, University of Houston, University of Louisville, University of Minnesota, University of Missouri, UNC Chapel Hill, Washington University in St. Louis, SDSU, Spring Finance Conference at Koc University, and the First European Center for Corporate Control Studies Workshop for helpful comments.

* Corresponding author. Tel.: +1 812 855 2698.
E-mail addresses: ycai@scu.edu (Y. Cai), msevilir@indiana.edu (M. Sevilir).
[1] Tel.: +1 408 554 5157.

0304-405X/$ - see front matter © 2011 Elsevier B.V. All rights reserved.
doi:10.1016/j.jfineco.2011.05.017

may limit competition from outside less-informed bidders, and reduce the acquirer's incentive to offer a higher premium in order to deter a competing bidder. Finally, greater information flow and communication between connected firms may affect the transaction costs of the deal by mitigating the need for advisory services of investment banks in initiating the transaction and identifying the synergy sources. Similarly, there could be a lower need for fairness opinions in connected transactions given the more informed position of the connected directors. The lower need for advisory services and fairness opinions, in turn, may manifest itself in a lower amount of transaction costs paid to investment banks. To examine these possible effects of board connections on M&A transactions, we study announcement returns, takeover premiums, long-run operating performance of the newly merged firm, as well as investment banking fees paid in a transaction.

In our sample of 1,664 US acquisitions between 1996 and 2008, we observe a board connection between the acquirer and the target in 9.4% of the transactions. In terms of dollar deal values, connected transactions represent 19.8% of the overall transaction volume. We find that the average acquirer abnormal return from two days before to two days after the acquisition announcement is 0.12% in first-degree connected transactions, and −2.33% in non-connected transactions. The difference is 2.45%, and significantly different from zero at the 5% level. In addition, we find lower takeover premiums in the presence of a first-degree connection. Interestingly, takeover premiums become even lower when the connected director is an executive at the acquirer. To the extent that executive directors possess greater information advantage and greater incentives to undertake the deal at a lower price compared to outside directors, this result supports the view that first-degree connections provide the acquirer with an information advantage and allow the firm to acquire the target at a more attractive price. We also find that the number of bidders in transactions with a first-degree connection is lower, compared to non-connected transactions. A board connection between the acquirer and the target may deter competition from outside bidders who fear the winner's curse more due to the presence of an informed bidder, consistent with the main prediction of winner's curse theories that the incidence and magnitude of the winner's curse is positively related to the number of bidders (Kagel and Levin, 1986). Furthermore, we show that the takeover premium in first-degree connections is lower when the number of competing bidders is smaller. These results favor the interpretation that a first-degree board connection leads the acquirer to have a greater bargaining power in merger negotiations by providing him with a more informed position about the target and by limiting the degree of competition from less-informed outside bidders. Finally, we find that investment banking fees paid as a percentage of deal size are lower in first-degree connected transactions, compared to non-connected transactions.

Similar to transactions with a first-degree connection, acquirer shareholders obtain higher announcement returns in transactions with a second-degree connection as well. In second-degree connected transactions, the mean acquirer announcement return is −0.65%, while in non-connected deals the mean acquirer return is −2.33%. The difference is 1.67% and significantly different from zero at the 5% level. Likewise, the average combined announcement return in second-degree connected transactions is 2.81%, while it is 0.97% in non-connected sample. The difference is 1.84%, and significantly different from zero at the 5% level. In addition, the post-deal operating performance of the combined firm is better in transactions with a second-degree connection compared to transactions with no connection, suggesting that such deals are associated with better performance in the long run as well.

Although we find that both types of board connections are related to greater acquirer announcement returns, our results suggest that the economic mechanism driving these superior returns is different between first- and second-degree connections. Communication and information advantage of first-degree connections appear to help the acquirer buy the target at a lower premium. In addition, limited competition from outside bidders in first-degree connections enhances the acquirer's ability to pay a lower premium for the target, and reduces the target's ability to ask for a higher premium. Communication and information advantage present in second-degree connections, on the other hand, appear to be associated with deals with greater overall value creation, as evidenced by higher combined announcement returns and better post-deal operating performance of the combined firm in such deals. An important difference between first- and second-degree connections is that the connected director in first-degree connections represents both acquirer and target shareholders, while in second-degree connections, the connected director at the acquirer represents acquirer shareholders and the connected director at the target represents target shareholders. Hence, connected directors in second-degree connections are more likely to undertake deals if they lead to superior combined announced returns. This might explain why we find second-degree connections are associated with greater overall value creation from the deal relative to first-degree connections.

An important concern for our analysis is that board connections do not arise randomly and they may be related to certain omitted firm characteristics which could independently affect M&A outcomes. To address such endogeneity concerns, in our regression framework we control for all important factors shown to affect M&A outcomes significantly such as acquirer size, deal size relative to acquirer size, financing of the transaction, and whether the deal is diversifying, among others. In addition, we conduct a number of robustness tests to alleviate the concern that our results might still be driven by factors omitted in our multivariate analysis. One possibility is that firms with talented and high quality directors are more likely to have board connections given that there may be a great demand for their directors. Such firms could also be more likely to engage in high quality M&A deals. It is also possible that firms with greater similarity, firms with previous business relations, and firms located at a closer distance to each other are more likely to have common directors and to generate better M&A outcomes when they merge. Another possibility is that it is the acquisition experience of the acquirer which explains our results. Firms with greater acquisition