

Option Grants to CEOs of Target Firms: Rent Extraction or Incentive Alignment?

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ABSTRACT

Managerial rent extraction is a non-trivial phenomenon during acquisitions: in a sample of 364 deals during 1999-2005, over one target CEO in four experiences compensation increases due to option grants received just before the acquisition while target shareholders suffer losses. Indeed, the top quartile of rent extraction CEOs pocket an average 19 million dollars from options granted prior to the acquisition while shareholders of rent extraction targets experience average abnormal returns of -36 percent during the three years ending just after the merger announcement. Rent extraction occurs in weakly governed companies. Targets exhibiting rent extraction are more likely to grant their CEOs lucrative options packages after starting negotiations with eventual acquirers, but less likely to negotiate higher premiums. Self-dealing CEOs benefit from stock option vesting periods and other restrictions that disappear when their firms are sold.

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Acquisitions provide unusually rich opportunities for profiting on insider information, an activity that violates securities laws. Officials from the top U.S. securities regulators met on August 18, 2006 to discuss emerging trends in insider trading. In the meeting, Joseph J. Cella, chief of the office of market surveillance at the Securities and Exchange Commission (SEC), stated on behalf of the commission: “We are certainly cognizant of the up tick [of insider trading] in merger-and-acquisition activity,” (Morgenson, 2006).

Stock options awarded to top managers of target firms often become immediately exercisable when the sale of the company is consummated. This occurs because “change in control” clauses, which are common to many CEO compensation contracts, allow option vesting periods and other restrictions to disappear as the company ceases to exist as a stand alone entity. This phenomenon provides CEOs and other top managers with the opportunity to increase their stock option holdings prior to an acquisition announcement and obtain huge payoffs when their firms are eventually sold.¹ In many circumstances, it is possible that these payoffs are illicit and are obtained as a result of insider trading.

These conjectures motivate the hypotheses we address in this paper. The rent extraction hypothesis posits that pre-acquisition option grants are designed to enrich target CEOs and not necessarily their firms’ shareholders. The alternative is the incentive alignment hypothesis which predicts that option grants to target CEOs prior to acquisitions will induce CEOs to work hard in getting a high offer for their firms and therefore more value for their shareholders.

Distinguishing between these two hypotheses in the context of firms to be sold is difficult because it is possible that both rent extraction and incentive alignment occur simultaneously. Therefore, our research design uncovers situations when rent extraction likely occurs, which are those when target CEOs, but not target shareholders, benefit from the acquisition. In a sample of 364 acquisitions during 1999-2005, we first identify 219 targets that experience negative abnormal returns during the three-year period ending one day after the acquisition announcement. In 102 of these cases, target CEOs experience an increase in their compensation due to options granted before the acquisition. Therefore, in approximately 47 percent of situations when target shareholder wealth declines, CEOs gain from option grants. We view these target firms as prime suspects of rent extraction. However, as we discuss later, it is possible that in certain situations actions by these firms could be consistent with an incentive alignment behavior.

Empirical tests reveal that firms suspected of rent extraction exhibit weak corporate governance. For these firms we also find that option-based pay increases to target CEOs are more likely whenever boards (1) are chaired by the

¹ Given their direct involvement in acquisition negotiations, CEOs likely know of the impending sale of their firm months before market participants do. Since most of the target’s stock price increase occurs during the four weeks before and up through the deal announcement date (Schwert, 1996), and because the firm’s sale causes option awards to immediately become exercisable (Cai and Vijh, 2007), CEOs can stockpile options prior to the sale and benefit from acquisition premiums paid for targets which in recent years are in the order of 30%.

CEO, (2) are busy, and (3) have a busy compensation committee.² These results are robust to numerous controls for CEO and firm specific characteristics. Our multivariate tests reveal that target firms in which rent extraction is suspected are more likely to initiate merger talks with potential acquirers, to file unscheduled option grants in the year of the acquisition, and to grant larger and more valuable stock options to their CEOs prior to the deal. These results suggest that, in the context of a firm's impending sale, option granting might be a covert form of insider trading. These findings, however, do not rule out the incentive alignment hypothesis because it is possible that option awards to these target CEOs motivate them to negotiate a higher premium for their firms and therefore obtain more value for the targets' shareholders.

Next, we present two pieces of evidence that strongly suggest that our suspect targets are in fact engaging in rent extraction. First, we find these firms more likely to grant their CEOs option awards *while* merger negotiations with their eventual acquirers are underway. Second, we also find that premiums negotiated by targets suspected of rent extraction are not larger than those negotiated by other targets. According to our multivariate tests, the premium occurring during the sale negotiation period is about 15 percent lower for targets in which rent extraction is alleged. In general, together with our earlier results, the new findings strongly indicate that the actions of our suspect firms are consistent with our rent extraction hypothesis but not with the incentive alignment alternative.

The results herein indicate that rent extraction has a material effect on the wealth of many CEOs. Based just on the last option grant received prior to the official acquisition announcement, the top quartile of rent extraction target CEOs receive an average payment of \$19 million. In contrast, shareholders of rent extraction targets experience buy-and-hold abnormal returns (*BHARs*) of about -36 percent during the three years ending one day after the merger announcement. Estimating shareholder returns to end one day after the merger announcement assures that the return will benefit from the takeover premium. The average two year (one year) target shareholder return before acquisition is -26 percent (-18 percent).

We consider the possibility that the lower premium obtained by some targets helps their CEOs secure employment in the combined firm. Results indicate that CEOs heading rent extraction targets are less likely to get a directorship or an executive position in the combined firm. In addition, direct evidence on rent extraction also comes from Securities laws violation related suits filed against certain targets and their top executives. We find rent extraction targets more

² Busy boards (compensation committees) are those in which the majority of the outside directors (committee members) have three or more directorships (Fich and Shivdasani, 2006).

likely to be sued after being acquired. Overall, these results are also opposite to the predictions of the incentive alignment hypothesis and consistent with rent extraction behavior.

Our findings have important public policy implications on the efforts by regulators to curb corporate malfeasance. On the one hand, we show that instances of rent extraction drop from 37 percent to 15 percent after the 2002 Sarbanes-Oxley Act (SOX) is promulgated.³ This result indicates that rent extraction has subsided but is not completely eliminated. On the other hand, the problem may soon reemerge because the SEC recently released an amendment proposal to Rule 14d-10 of its 1934 Securities Act. The rule change would provide a safe harbor allowing the compensation committee of a target's board of directors to approve employment compensation, severance or other employee benefit arrangement for its executives during a tender offer negotiation.⁴ The proposed amendment may also severely curtail the potential liability of corporate insiders that violate insider trading laws as prescribed under Section 20A of the 1934 Securities Act. Such *laissez faire* attitude would pave the way for target shareholder expropriation during acquisitions by top managers.

The paper proceeds as follows. Section I reviews the appropriate literature. Section II describes the data we use in this study. Section III presents our empirical analyses. Section IV presents additional evidence in support for the rent extraction hypothesis. Section V concludes.

I. Literature Review

A. Evidence on Rent Extraction and Incentive Alignment

The efficiency of top management compensation contracts in general, and whether stock options benefit top managers more than shareholders in particular, continues to be the subject of considerable academic debate. Underlying this debate are two popular hypotheses: incentive alignment and rent extraction. The incentive alignment hypothesis states that an increase in equity holdings causes top managers to take actions that will enhance shareholder wealth. In contrast, the rent extraction hypothesis states that such increase occurs in anticipation of good news and is used by top managers with private information for their own benefit. Recent studies report evidence in support of the

³ Section 403 of SOX requires public company officers and directors to report their receipt of stock options within two days of the grant.

⁴ See SEC release 2005-176. The existing Rule 14d-10 of the 1934 Securities Act provides that no bidder may make a tender offer unless “the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.” Although this rule appears to be simple in concept, courts have struggled when applying it to the variety of arrangements that exist or are entered into with executives of a target company (who are usually stockholders as well) in connection with an acquisition transaction. These arrangements often include severance payments, stay bonuses, non-compete payments, and other cash and equity compensation arrangements designed to retain and provide incentive to top managers.

incentive alignment hypothesis. For example, Hall and Murphy (2002) find a positive association between CEO stock-based compensation and firm value. Hanlon, Rajgopal, and Shevlin (2003) show that future earnings are positively associated with stock option grants. Fich and Shivdasani (2005) find that stock option plans for outside directors enhance firm performance. In contrast, other studies support the rent extraction hypothesis. For instance, Yermack (1997) finds that option grants are timed in anticipation of good news and Carpenter and Remmers (2001) show that top managers use their private information to time exercises of options. Bebchuk, Fried, and Walker (2002) indicate that the pattern of granting at-the-money options to CEOs is pervasive and designed to benefit the executives and not necessarily the firms' shareholders.

In the situation in which the sale of the firm is imminent, the incentive alignment perspective means that options granted to top managers prior to a merger deal are aimed at increasing firm value because the target CEOs, who are often directly involved in the negotiations with the acquiring firm, will work hard to get the highest possible price for their firms. In contrast, the rent extraction hypothesis implies that such grants are designed to enrich top managers. In a closely related paper, Heitzman (2006) finds that equity awards before an acquisition are used by boards to align CEO's and shareholders' incentives. He argues that such grants are more likely explained by incentive alignment issues within an acquisition setting and that there is no evidence that opportunistic actions by the target CEO drive observed equity grants prior to a firm's sale. Heitzman's conclusions are opposite to those we present in this paper. We believe that our empirical design enables us to show that the actions of many target firms are consistent with those predicted by the rent extraction hypothesis.

B. Acquisitions and Payoffs to CEOs of Target Firms

Recent studies show that target CEOs might be willing to accept lower acquisition premiums. There is evidence that this can occur when acquirers promise target CEOs a high-ranking managerial post, such as a board seat in the combined firm, after the acquisition is completed (Hartzell, Ofek, and Yermack, 2004, and Wulf, 2004). Although director compensation is often a fraction of what CEOs earn, it is possible that target CEOs seek a board seat in the combined firm to partially mitigate the future income they will lose when their firms are acquired. This probably explains why certain vehicles aimed at providing compensation relief to CEOs of firms that are sold, such as golden parachutes,⁵ are often favorably received by investors (Lambert and Larcker, 1985).

⁵ A golden parachute is a clause in an executive's employment contract specifying that s/he will receive large benefits in the event that the company is acquired and the executive's employment is terminated. These benefits, which are provided to reduce perverse incentives such as derailing a profitable acquisition, may include severance pay, cash bonuses, stock options or a combination of these items.

Stock and option holdings may provide a powerful incentive for CEOs to sell their firms. Cai and Vijh (2007) show that CEOs with higher illiquid equity and option holdings are more likely to get acquired, accept a lower premium, and offer less resistance. Cai and Vijh argue that, in the case of target CEOs, incentives to sell their firms arise from the adverse effect of illiquidity on personal valuation of securities. Meulbroek (2001) and Hall and Murphy (2002), among others, show that the executives' value of a firm's stock and option holdings can be much lower than the market value. They argue that the difference arises because executives are often undiversified and unable to sell their stock or hedge their options due to several liquidity restrictions. This difference might explain (1) why CEOs who are able to sell their firms' stock do so when they get new option grants (Ofek and Yermack, 2000) and (2) the early exercise behavior of executives documented by Hemmer, Mastsunaga, and Shevlin (1996) and by Bettis, Bizjak, and Lemmon (2004). Since the equity and option holdings of CEOs play an important role in their incentives to sell their firms, our multivariate tests control for the potential effect that these variables may have in the incentive alignment or rent extraction behavior of target CEOs.

C. Corporate Governance and Payoffs to Shareholders of Target Companies

When a firm is targeted, the board has the authority and responsibility to evaluate an acquisition offer. When deals are approved, the appropriate corporate officers of both firms sign a merger agreement and the target's board files a proxy statement detailing the arrangement with the SEC. The target's board is also responsible for distributing the agreement and calling for a special meeting of the target shareholders where a formal vote ratifying the acquisition takes place. This process provides the target's board with considerable discretion over the ultimate success of an acquisition. For example, boards can adopt a variety of antitakeover measures, such as poison pills, in order to increase their ability to either defeat a takeover offer (Malatesta and Walkling, 1988) or enhance their bargaining position with the bidder (Comment and Schwert, 1995). To address this issue, our tests control for the Gompers, Ishii, and Metrick (2003) index which adds 24 antitakeover provisions tracked by the Investor Responsibility Research Company (IRRC).

Several papers document that the composition and incentives of the board of directors play an important role in determining the welfare of target shareholders in acquisitions. For example, Bange and Mazzeo (2004) report that firms with individuals concurrently holding the titles of CEO and chairman of the board are more likely to receive

bypass offers that generate higher target shareholder gains.⁶ Harford (2003) argues that, at the margin, the loss of directorship income may induce outside directors to resist acquisitions that are in the shareholders' interests. Cotter, Shivdasani, and Zenner (1997) find that a majority of outside directors enhance target shareholder gains. In addition, target shareholders obtain larger takeover premiums when institutional share ownership is high (Cotter and Zenner, 1994), and when top management has greater stock ownership (Song and Walkling, 1993).

The existing literature documents the importance of corporate governance in determining the way in which target shareholders fare during acquisitions. Therefore, we investigate the governance characteristics of targets in which opportunistic option granting by CEOs and rent extraction are suspected. We also study whether the governance of firms where rent extraction is alleged is different from the governance of other firms.

D. Securities Laws Violations around Acquisitions

Previous studies document that individual investors have made illicit profits in anticipation of acquisitions. For example, Keown and Pinkerton (1981) provide evidence of excess returns earned by investors in acquired firms prior to the first public announcement of planned mergers. These authors argue that these excess returns arise due to leakages of information of the impending transaction which violates Rule 10b-5 of the Securities Exchange Act of 1934.

Jarrell and Poulsen (1989) also document share price run-ups prior to acquisition announcements along with abnormally high volume. Meulbroek (1992) uses data from court filings to show that at least some of the pre-acquisition trading volume is driven by illegally informed agents. However, there are alternatives to the insider trading hypothesis to account for pre-acquisition price and volume run-ups. For example, according to Jensen and Ruback's (1983) market anticipation hypothesis, it is also possible that market participants foresee the acquisition, and their trades impound this anticipation into prices. Recently, Song and Walkling (2007) find that market anticipation of an acquisition explains price run-ups prior to the transaction. Unlike these studies, which investigate the profits made by investors prior to an acquisition, our paper focuses on the target shareholder wealth effects and the legal implications of granting options to target CEOs prior to the imminent sale of their firms.

⁶ They define a bypass offer as an unsolicited tender offer for a controlling majority interest in a target that is allegedly unanticipated by management and by the board of directors.

II. Data and Sample Selection

We begin with 3,732 completed acquisitions of public U.S. target firms announced during 1999-2005 and tracked by the Securities Data Company (SDC) in its mergers and acquisitions (M&A) database. Next, we require that target firms have data available from the Center for Research in Security Prices (CRSP) and from Compustat. This requirement reduces our sample to 2,405 deals. We restrict observations to those where data for target firms are available from the Investor Responsibility Research Center (IRRC). This restriction reduces the sample to 551 acquisitions. Since our study focuses on option grants prior to merger announcements, we exclude 187 targets that do not grant options to their CEOs during the three fiscal years prior to the announcement date as reported in the Thomson Financial's Insider Filing database. Our final sample consists of 364 completed acquisitions announced during 1999-2005.⁷

Panel A of Table 1 reports the industry distribution of the 364 mergers. Based on the Fama and French (1997) industrial classification, our sample appears well scattered across several industries. However, the Business Services industrial classification exhibits some clustering with just over 15 percent target firms belonging to that industry. Therefore, to account for the potential effect of a target's industry, we include industry and calendar year dummies in appropriate multivariate tests.

Panel A, Table 1 also reports the temporal distribution of the 364 mergers. Our sample spans periods of both economic expansion and recession. The annual number of mergers announced is higher at the beginning and at the end of our sample period, which coincides with periods of economic expansion when the stock market valuation is higher. Conversely, merger activity is lower during the 2002-2003 period of economic contraction. Rhodes-Kropf and Viswanathan (2004) show that stock market drives merger activity. They find that bull markets allow overvalued acquirers to buy undervalued targets. Their results are consistent with those in Shleifer and Vishny (2003) who also find the effect of stock market health on the number of acquisitions.

In Panel B, Table 1 we report the mode of acquisition, method of payment, attitude, and relatedness of the mergers in our sample. We classify a merger as related if both the target and the acquirer belong to the same Fama and French (1997) industrial classification. Based on this classification, we note that over 60 percent of the deals involve firms in related industries. We also note that our sample includes more tender offer and cash deals. Among the 364 acquisitions, 83 are tender offers and 155 are cash acquisitions. The overwhelming majority of the sample (over 95

⁷ Our sample begins in 1999 because the coverage of option grants is rather limited in the Thomson Financial database prior to 1996.

percent) consists of friendly mergers. Untabulated information indicates that the average (median) target in our sample has a market capitalization of \$3.3 billion (0.97) and is purchased for \$4.76 billion (1.5). These figures are similar to those in Grinstein and Hribar (2004). They study acquisitions during 1993-1999 and report an average deal value of \$4.7 billion for targets in their sample.

III. Rent Extraction vs. Incentive Alignment

A. Determinants of Rent Extraction

A.1. Univariate Tests

Our research design identifies situations in which rent extraction is likely to occur. If the incentives of CEOs and shareholders are truly aligned, then their wealths are likely to rise and fall at the same time. In contrast, the most egregious cases of rent extraction are likely to occur when CEO wealth increases but shareholder wealth does not. We estimate target shareholder returns for the three years ending the day after the merger is announced.⁸ We also estimate the change in target CEO option-based compensation during the same period. This estimation window insures that both shareholders and CEOs will benefit from the takeover premium. Panel A of Table 2 disaggregates the returns to target shareholders for different changes in CEO option-based pay. We flag 102 cases in which CEO option-wealth increases even though target shareholders experience losses. We view these instances as cases of potential rent extraction.

It is possible that within these 102 cases, the incentives of CEOs and shareholders are truly aligned and that the dissimilar fate of CEOs and shareholders in these instances is due to other factors such as luck. Garvey and Milbourn (2006) find that CEOs are generally rewarded for good luck but not punished for bad luck. However, the situations that we identify appear to be those in which CEOs are actually rewarded for bad luck. Still, given the possibility that some or all of the 102 flagged targets are cases of bad luck, we refer to these firms as rent extraction suspects.

Panel B documents that the return patterns associated with rent extraction suspects and other target firms are different. For example, among the 364 target firms, companies where rent extraction is alleged do very poorly until the last option grant date prior to the acquisition. During this period, rent extraction suspects earn average buy-and-hold abnormal returns (*BHAR*) of about -59 percent.⁹ In contrast, other firms exhibit a healthy *BHAR* of about 29 percent during the same period. Given the way in which we identify our rent extraction suspects, such finding is not very

⁸ Our results are qualitatively similar when we use the two and one year returns prior to the acquisition announcement.

⁹ We calculate *BHARs* following Barber and Lyon (1997). These authors advocate the use of *BHARs* over *CARs* for longer term returns.

surprising. Nonetheless, fortunes appear to reverse for rent extraction suspects after the last option grant date until 10 business days prior to the deal announcement (AD-10).¹⁰ During that period, the mean *BHAR* to rent extraction suspects improves to 1.14 percent, which is significantly different from the previous performance of the same firms at the 1 percent level. These findings hold when we replace *BHARs* by cumulative abnormal returns (*CARs*).¹¹ Moreover, according to row (3) in Panel B, from AD-10 until AD+1 (the day after the deal is announced) rent extraction suspects outperform other targets. During this 11-day period, rent extraction suspects earn a *BHAR* of 34.95 percent while other targets earn a *BHAR* of 21.81 percent. This change in performance, which occurs after the last sets of pre-acquisition options are granted, suggests that timing of options for rent extraction suspects is not incidental.¹² Moreover, as we will show later, this performance improvement appears to enhance the wealth of target CEOs who receive option grants prior to selling their firms. However, the improvement does little to help shareholders recover from the targets' previous underperformance.

Panel C, Table 2 provides key characteristics for our target firms sorted by alleged rent extraction. In general, the two groups do not exhibit significant differences in market capitalization, assets, or leverage. In contrast, corporate governance characteristics described in Panel D of Table 2 display significantly different values when the sample is classified according to rent extraction. For example, rent extraction suspects appear more likely to feature (1) CEOs who chair their boards, (2) busy boards, and (3) busy compensation committees. Given these characteristics, it appears that alleged rent extraction occurs when corporate governance is weak.

Another piece of evidence on the purported rent extraction behavior of certain target firms comes from the pattern of options granted to CEOs prior to the deal. Table 3 presents option granting activity by our targets. In Panel A of Table 3 we present the Black-Scholes (1973) value of the options granted to target CEOs during the last four years of the targets' life which we adjust for dividend payouts (Merton, 1973) when necessary. Panel B of Table 3 presents the number of options granted to the CEOs of targets during the same period. In general, all targets increase the value and quantity of options granted to their CEOs from three years prior to the acquisition (AY-3) to the year of the acquisition (AY0). However, rent extraction suspects outpace other firms both in terms of value and in the number of options granted. From AY-3 to AY0, results in Panel A of Table 3 indicate that the average value of options granted by rent extraction firms increases tenfold from \$658,000 to \$6,727,000. In contrast, options to other targets increase by less

¹⁰ We calculate returns ending 10 business days prior to the announcement to prevent the takeover premium from entering into the calculation and biasing the result. However, results are qualitatively similar when returns end in day AD+1.

¹¹ We calculate *CARs* following Dodd and Warner (1983).

¹² The results are qualitatively similar using annualized returns.

than 20 percent during the same period, from \$3,350,000 to \$3,926,000. Similar increases occur when we study the number of options granted in Panel B. Rent extraction suspects go from awarding their CEOs an average of 38 thousand options in AY-3 to 387 thousand in AY0, while non-rent extraction firms remain quite stable during the same period going from 205 thousand options to 203 thousand.

The rapid increase in both the number and value of options granted from AY-3 to AY0 suggests a calculated move by rent extraction suspects in increasing their CEOs' level of option holdings. However, it is possible that the patterns of options granted we document are due to the fact that, in recent years, smaller firms have tended to use options more intensively (Oyer and Schaefer, 2005). To address this issue, we assemble a matching sample of non-target firms for our entire sample of 364 targets. Matching firms are identified by controlling for firm size, industry, and pre-event performance as suggested in Barber and Lyon (1996). We use total assets in the year prior to the acquisition to proxy for firm size, industry-adjusted return on assets (ROA) to proxy for firm performance, and 2-digit SIC codes to control for industry classification. Panels C and D of Table 3 report the Black-Scholes value and the number of options granted to CEOs from AY-3 to AY0, respectively. In each of the panels, we report dollar values and quantities of options granted to CEOs of target and matching firms sorted by the target firms' alleged rent extraction classification. Results using matching firms are in line with our earlier findings. Rent extraction targets surpass their matching firms both in terms of the value and number of options granted in the year of the deal (AY0). During AY0, the value of the option granted by rent extraction target CEOs exceeds that of matching firms by about \$3.7 million. These results also suggest a deliberate attempt by targets where rent extraction is presumed to boost the option holdings of their CEOs in anticipation of the acquisition.

The results in Tables 2 and 3 suggest that rent extraction suspects appear to time their option grants prior to acquisitions. Nevertheless, it is possible that these findings are consistent with incentive alignment if the CEOs of these firms negotiate higher premiums when their firms are sold. Moreover, given the univariate nature of the tests in Tables 2 and 3 and due to the potential confounding effect of key variables, we now turn to our multivariate analyses.

A.2. Multivariate Analyses

Actions that CEOs take to expropriate shareholders and the facilitation of such behavior by corporate boards are likely to have their own determinants. Therefore, in order to study the characteristics of CEOs and firms more likely to perpetrate rent extraction, we run a set of four bivariate logit regressions in which the dependent variable is "1" for the 102 targets where rent extraction is presumed and is "0" otherwise. Table 4 reports the results for this test.

Characteristics often associated with weak corporate governance structures exhibit statistically significant coefficients. Estimates indicate that alleged rent extraction is more likely to occur when CEOs also hold the board's chairmanship, when boards and compensation committees are busy, and when boards are hand-picked.¹³ In addition, the natural log of assets, our proxy for firm size, exhibits a negative and statistically significant coefficient in all three regressions. This result suggests that rent extraction might be easier to carry out in smaller targets. We note that our regressions include a (0,1) indicator for golden parachutes for target CEOs. Hartzell, Ofek, and Yermack (2004) find that lump sum payments received by target CEOs are lower if the executives are provided with golden parachutes. Therefore, it is possible that firms with golden parachutes are less likely to be associated with rent extraction as well. In our regressions, the golden parachute indicator exhibits a negative, albeit statistically insignificant, coefficient.

Many target CEOs can expect to incur substantial personal losses as a result of their firms being sold. This happens because CEOs will forgo the compensation they would have earned if the acquisition had not occurred. Following the existing literature, we estimate the lost compensation each CEO in our sample incurs as a result of the deal.¹⁴ Our logit regressions also include the natural log of the target CEOs' present value of lost compensation when their firms are acquired. The results indicate that lost compensation has a meaningful effect in triggering rent extraction. The natural log of the target CEOs' present value of lost compensation exhibits a positive and significant coefficient in all four logit regressions. In terms of the marginal effects implied by this variable, we estimate that an expected \$10 million in lost CEO compensation increases the likelihood of rent extraction by about 2 percentage points. To put this result into context, the mean (median) lost compensation for target CEOs in our sample is approximately \$31 million (\$19 million).

Our estimates also suggest that governance structures appear to have a material effect on the likelihood of rent extraction. Regarding the marginal effects associated with our coefficient estimates, a busy board increases the probability of rent extraction by 16.58 percentage points. Likewise, a busy compensation committee raises it by 14.76

¹³ Hand picked boards are those in which the majority of the outside directors join the board after the current CEO is appointed. This variable, which measures the potential influence the CEO has over the selection of outside directors, is partially based on that in Shivdasani and Yermack (1999) and in Coles, Daniel, and Naveen (2007).

¹⁴ To compute the lost compensation we follow Fich and Shivdasani (2007) and use information on salary, bonus, other annual compensation, long-term incentive payout, and value of restricted stock and option awards as reported in the proxy statements. We assume that all CEOs retire at age 70 and that CEOs in our sample who are at least 70 years old expect to stay in office for one more year before retiring. Following Yermack (2004), we assume that the probability of departure increases by 4% each year due to acquisitions, delistings, or other turnover reason. We also assume that salary and bonus would increase by 2% from that received during the year prior to the acquisition when the target's performance is above the Fama and French (1997) median industry ROA. This assumption follows Bebchuk and Grinstein (2005), who report a 40% increase in salary and bonus for the period 1993-2003. We assume that the probability of departure increases by an additional 2% when firm performance is below the median industry performance. To estimate the present value of lost compensation, we use a real discount rate of 3% to discount cash flows.

percentage points. Fich and Shivdasani (2006) report that non-busy boards increase the probability that underperforming CEOs are fired for poor performance by about 6.94 percentage points while busy boards raise the same probability by only 0.59 percentage points. They argue that busy boards are overtaxed and unable to effectively monitor their CEOs. In addition, Core, Holthausen, and Larcker (1999) find that busy boards are more likely to overpay their underperforming CEOs. In line with these studies, our results indicate that target CEOs might be better able to use option grants to expropriate target shareholders prior to an acquisition under busy boards.

Our regressions also confirm that powerful CEOs might be more disposed to extract rents from their firms' shareholders. Grinstein and Hribar (2004) show that acquiring CEOs who also hold the title of chairman of the board are more likely to draw a bonus for acquisitions that do not enhance shareholder wealth. Our findings indicate that CEOs who also chair their board are 13.73 percentage points more likely to extract rent from target shareholders when their firms are sold. In regression (4) we include a dummy variable to control for the possibility that target CEOs are overconfident.¹⁵ Malmendier and Tate (2005) find that overconfident CEOs are more likely to make investment errors. Our results indicate that being an overconfident CEO is unrelated with the probability of becoming a rent extraction target.

B. Deal Initiation

We read the S-4 and 13D filings by the acquirer firms and form DEF-14A filed by the target firms.¹⁶ These filings describe the history of the deal. We complement this information with the synopsis for each transaction provided in the SDC database. This procedure enables us to ascertain whether the target (or the acquirer) initiates the deal. Under the rent extraction theory, initiating the deal will allow firms enough time and information to stockpile options in anticipation of the acquisition. Put differently, if rent extraction is the goal of certain target CEOs in order to benefit from the acquisition premium and the removal of vesting restrictions, then approaching potential buyers to trigger the sale might be part of the plan. In contrast, under incentive alignment, managers may consider that selling a poorly performing firm quickly may avert further value deterioration. Therefore, in order to preserve as much value as

¹⁵ This dummy variable, which is defined following Malmendier and Tate (2005) long-holder measure, is "one" when a CEO owns options at the beginning of the last year of options' life that are at least 40% in the money. The variable is "zero" otherwise.

¹⁶ According to the SEC, form S-4 may be used for registration of securities to be issued (1) in a transaction of the type specified in paragraph (a) of Rule 145 (of the 1933 Act); (2) in a merger in which the applicable state law would not require the solicitation of the votes or consents of all of the security holders of the company being acquired; (3) in an exchange offer for securities of the issuer or another entity; (4) in a public reoffering or resale of any such securities acquired pursuant to this registration statement; or (5) in more than one of the kinds of transaction listed in (1) through (4) registered on one registration.

possible, managers might accelerate the selling process by initiating the deal. In an attempt to distinguish between these views, we run the following logit model:

Deal initiation (0,1) = alleged rent extraction (0,1) + target, deal, CEO, board characteristics (1)

The dependent variable in model (1) is “1” if the target company initiates the deal and is “0” if the buyer initiates it. In a few instances, we are unable to establish the party that initiates the deal. These firms are coded as “0” in our analysis. We note that this situation would cause us to miss some targets that initiate deals, and would bias us against uncovering an association between rent extraction and deal initiation. The key independent variable is a (0,1) indicator for alleged rent extraction.

We run four different specifications based on model (1) and report the results in Table 5. We begin by evaluating whether poor performance motivates targets to approach acquirers. In regressions (1), (2), and (3), the coefficient for the targets’ market-adjusted return is not statistically significant at conventional levels. In regression (4), the coefficient for the targets’ ROA, a frequently used proxy for operating performance, also fails to attain statistical significance. These results cast doubt on the idea that underperforming firms approach their eventual acquirers in an effort to preserve value and are opposite to the predictions of the incentive alignment hypothesis. In contrast, the findings in all regressions also indicate that rent extraction suspects are more likely to initiate the deal. This finding is robust to numerous controls, including the relative size between buyers and targets, the deal’s attitude, and whether the deal is paid in cash.¹⁷ The marginal effect implied by the coefficient estimate for alleged rent extraction indicates that these targets are 14.21 percentage points more likely to initiate the deal.

C. Unscheduled Option Grants prior to Acquisitions

We analyze unscheduled option grants given to the CEOs of our target firms to examine whether rent extraction suspects are more or less likely than other targets to undertake this activity. The rent extraction hypothesis predicts that self-dealing managers will increase their options prior to their firms being sold to benefit from the automatic vesting the sell will trigger on these awards. Yermack (1997) and Aboody and Kasnik (2000) indicate that for most CEOs of public companies stock options are awarded once each year. Therefore, it is likely that managers trying to increase their option holdings before acquisitions might not be able to receive additional grants during the annual board meeting in which options are regularly awarded. If this occurs, options would have to be issued at unscheduled times.

¹⁷ We lose 84 observations related to non-publicly traded acquirers. However, excluding all acquirer-specific control variables from the regressions does not alter the inferences related to the rent extraction indicator.

We study the option granting patterns for our target companies. In line with previous studies, most of our target firms grant options once a year. Boards schedule their meetings at regular intervals. Some boards use the same calendar date of the month to meet, such as the third day of the month each month, and will meet during the next business day if such day happens to fall on a weekend or holiday. Other boards pick a certain day of the week during a certain week, such as the second Tuesday of every month. We classify a grant as a regular or scheduled option award if it is dated within 14 days of the one-year anniversary of a prior grant. Grants are classified as unscheduled otherwise.

We use our classification for the timing of the grants to construct a (0,1) indicator variable that equals “1” if at least one grant is unscheduled and “0” otherwise. This indicator is the key dependent variable in the following bivariate logit model:

$$\text{Unscheduled grant (0,1)} = \text{alleged rent extraction (0,1)} + \text{firm, CEO, board characteristics} \quad (2)$$

To capture a possible pattern of unscheduled option granting prior to the acquisition, we run four separate regressions based on model (2) for each of the time intervals [AY-3, AY-2], [AY-2, AY-1], [AY-1, AD], and [ID, AD], respectively.¹⁸ We report the results in Table 6. In the estimation, we include prior stock performance because it is possible that an unscheduled award is issued to reward exceptional performance. In addition, it is also possible that unscheduled option awards are issued to persuade entrenched managers to go along with an acquisition. To address this possibility, we also control for various governance- and CEO-specific characteristics.

The key finding in Table 6 is that rent extraction suspects are more likely to file unscheduled grants, particularly as the acquisition date approaches. In fact, while the rent extraction (0,1) variable is not statistically significant in the [AY-3, AY-2] interval, the same indicator becomes progressively more significant during [AY-2, AY-1], and [AY-1, AD]. In terms of the marginal effect implied by the coefficient estimate in the second regression (0.72, p -value = 0.07), during [AY-2, AY-1], rent extraction firms are 12.67 percentage points more likely to issue an unscheduled option grant to its CEO. According to regression (3), this probability more than doubles to 26.56 percentage points during the year of the acquisition and the coefficient is significant at the 1 percent level. Moreover, regression (4) indicates that unscheduled grants are 19.42 percentage points more likely to be issued by targets in which rent extraction is presumed after deal negotiations with their eventual acquirer have begun. This pattern of option granting provides additional

¹⁸ “AY” denotes the year the acquisition is announced, “ID” denotes the date when acquisition negotiations begin, and “AD” is the acquisition announcement date.

evidence of the calculated efforts by rent extraction suspects to increase their CEOs' option holdings in anticipation of the acquisition.¹⁹

D. Option Grants during Merger Negotiations

Our previous empirical tests indicate that targets in which rent extraction is presumed are more likely to grant unscheduled option awards after negotiations with the eventual acquirer have started. The legality of this activity hinges on the interpretation of Rule 14d-10 of the 1934 Securities Act. This rule proscribes “bidders from making a tender offer unless the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.” While this rule appears to be simple in concept, courts have wrestled on how to interpret it in the context of a variety of compensation arrangements of top executives of target companies (who are often shareholders as well). Moreover, if target executives increase their option holdings due to their knowledge and participation in the acquisition then these individuals might also be in violation of Section 20A of the 1934 Act which penalizes insider trading. Specifically, Section 20A(a) states that “any person purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction...” If option grants during merger negotiations are illegal, then it would be of interest to uncover the characteristics of targets more likely to undertake such activity. To investigate this issue we run a bivariate logit model as follows:

$$\text{Option granted during negotiations (0,1)} = \text{alleged rent extraction (0,1)} + \text{other controls} \quad (3)$$

In model (3), the dependent variable is “1” if at least one option award is granted to the CEO of the target firm after merger negotiations with the eventual acquirer are in progress and is “0” otherwise. As with the deal initiation, we are able to determine the date in which negotiations begin by reading the different filings and literature describing the history of each transaction. Similar to our previous models, the key independent variable is an indicator for alleged rent extraction.

We estimate four different logit regressions based on model (3) and report our findings in Table 7. The coefficient estimate for alleged rent extraction is positive and statistically significant at better than the 1 percent level in all four regressions. The marginal effect implied by the coefficient estimate indicates that rent extraction suspects are 23.4 percentage points more likely to issue an option award to their CEOs once merger negotiations with the eventual buyer

¹⁹ The results are qualitatively similar when we use percentage of the value of unscheduled grants in each period as a dependent variable in OLS regressions.

have begun. This result suggests that targets suspected of rent extraction are truly expropriating shareholders. This situation is more likely to be flagrant if the consideration to be paid for the target is already agreed upon.

E. Negotiated Premiums for Target Firms

So far, the results related to targets where rent extraction is alleged indicate that these firms (1) exhibit weaker governance structures, (2) grant larger and more valuable option awards to their CEOs prior to being sold, (3) initiate their own sale, (4) grant unscheduled option awards to their CEOs, and (5) grant options to their CEOs after merger negotiations with their eventual buyer are ongoing. This evidence strongly suggests that targets in which rent extraction is alleged are really doing so. However, we recognize that this evidence is largely circumstantial, particularly if the same group of targets is able to obtain a higher offer for their firms and therefore more value for their shareholders. Put differently, if the premium obtained during the negotiation period of our suspect firms is higher than that of other targets, then we could not reject the incentive alignment hypothesis in favor of the rent extraction hypothesis.

To investigate this issue, for our entire sample of 364 deals, we estimate *BHAR* from the deal initiation date until one day after the acquisition announcement [ID, AD+1] and from the initiation date until the date when the deal is completed [ID, ED]. We refer to these *BHARs* as negotiated premiums. Panel A of Table 8 reports all *BHARs* sorted by whether there is option granting after merger negotiations are underway. In general, results suggest that premiums obtained are higher for firms that do not grant options during the negotiation intervals. However, mean and median differences are not statistically significant.

In Panel B of Table 8, we split the 95 firms that grant options during negotiation by our classification of alleged rent extraction. The results of these tests indicate that rent extraction suspects do not earn higher negotiated premiums for their firms. Our estimates show that the mean (median) premium is about 8 percentage points (16) lower for targets where rent extraction is believed. Nonetheless, mean and median differences are not statistically significant.

Given the univariate nature of these tests, we use the *BHARs* as dependent variables in a set of regressions in which two different (0,1) indicators, one for alleged rent extraction and the other for option grants during merger negotiations, are the explanatory variables of interest. Panel C reports the results of these tests. The indicator for options granted during the merger negotiation period is significantly negative in the [ID, AD+1] period as well as in the [ID, ED] interval. According to regressions (1) and (3), the coefficient estimates related to this variable indicate that during these windows *BHARs* are about 9 percentage points lower. In the same regressions, the alleged rent

extraction indicator exhibits coefficients that are statistically indistinguishable from zero, indicating that targets identified as rent extraction fail to negotiate higher premiums. In regressions (2) and (4), we interact the rent extraction indicator with the grants during negotiations indicator and use the interaction term as an additional independent variable. Coefficient estimates for this interaction variable indicate that rent extraction targets that grant option awards to their CEOs while their firms' sale is being negotiated earn significantly lower negotiated premiums. Indeed, these firms earn premiums that are approximately 15 percentage points lower during [ID, AD+1] and about 17 percentage points lower during [ID, ED]. These results are robust to controls for several target and deal characteristics, some of which exhibit coefficients in the expected direction. For instance, as in Cotter and Zenner (1994), targets with high institutional ownership obtain higher premiums during deal negotiations.

The tests in Table 8 reveal that targets that grant their CEOs options when deal talks have started do not obtain higher premiums during the negotiation period. This result is counter to theories of incentive alignment. Moreover, together with our previous results, the new findings support the rent extraction hypothesis which predicts that the pattern of option granting by many targets prior to acquisitions is aimed at enhancing the wealth of top managers but not that of shareholders.

IV. Additional Evidence

A. Are Target CEOs Trading Premium for Power?

Our tests show that targets suspected of rent extraction appear to be expropriating shareholders because they do not negotiate higher premiums. Earlier research by Hartzell, Ofek, and Yermack (2004) and by Wulf (2004) finds that target CEOs who secure a directorship or other position of power in the combined firm are associated with lower premiums. In our case, it is possible that CEOs of targets suspected of rent extraction are also more likely to get a board seat or other employment in the combined firm. If this occurs, the prospect of obtaining the position in the merged firm might also explain the lower premiums these CEOs negotiate for their firms. To test this conjecture, we collect and review board and executive appointments for the acquiring firms after deals in our sample are executed. We also pay close attention to the composition of the board of directors of the acquiring firm during the year of the acquisition. We believe that acquirers' board membership during the year of the deal is important because if a target CEO is already seating on the acquirer's board, accepting a lower premium for his firm may enable the target CEO to keep the directorship in the combined firm.

In Table 9, we run bivariate logit regressions of the probability that target CEOs obtain a position of power in the combined firm.²⁰ The dependent variable in the logit specification is “1” for target CEOs that obtain a position in the combined firm or hold such position during the year the deal is executed. Altogether, we run four different regressions controlling for various target- and deal-specific variables. Present in all regressions is a (0,1) dummy variable that is “1” for rent extraction targets and is “0” otherwise. Coefficient estimates in all four regressions are negative and statistically significant for our rent extraction dummy. This result casts doubt on the idea that, for these firms, getting a position in the combined firm would entice rent extraction CEOs to negotiate or accept lower premiums. A more plausible explanation is that target CEOs of rent extraction firms exhibit a record of sub par performance in their own firms and are therefore unattractive candidates for a position in the combined firm. Another explanation for the result is that, by obtaining a position in the combined firm, target CEOs risk having their options not vest when the acquisition is completed. In terms of the marginal effect implied by the coefficient estimates in Table 9, rent extraction CEOs are about 13 percentage points less likely to obtain employment in the combined firm. We note that this result obtains in all specifications and is robust to several target- and deal-specific control variables. Moreover, some of the control variables generate inferences in agreement with our expectations. For example, when deals are hostile target CEOs are 33 percentage points less likely to obtain a position in the combined firm.

B. Rent Extraction and Lawsuits

Class action lawsuits are a likely outcome of shareholder expropriation. Earlier tests show that rent extraction targets are more likely to grant options to their CEOs when acquisition negotiations are underway. It is possible that such option granting patterns violate Rule 14d-10, and/or Section 20A of the 1934 SEC Securities Act and trigger subsequent lawsuits. However, it is also possible that the evidence is insufficient to find target firms guilty of willful misconduct for granting options this way, which would deter shareholders, regulators, and other potential plaintiffs from filing lawsuits which may be dismissed.

Bhattacharya and Daouk (2002) argue that difficulty in enforcing existing securities laws and regulations enhances the frequency of insider trading. The lack of enforcement could be costly to firms and shareholders. In a study involving several countries, these authors find a positive association between the incidence of insider trading and a country’s cost of capital. Ferris and Pritchard (2001) argue that the Private Securities Litigation Reform Act of 1995 (PSLR) makes it more difficult to win financial misconduct class action suits because the Act now requires plaintiffs to

²⁰ We consider directorship positions as well as executive appointments such as CEO of the acquirer or a subsidiary, chief financial officer, chief operating officer, chairman, vice-chairman, president, or vice-president in the merged firm.

“stay” discovery while motions to dismiss are pending. Consequently, the PSLR Act has significantly lowered the incidence of both frivolous and meritorious shareholder lawsuits. Moreover, since the PSLR passed, cases in which egregious offenses are committed are eventually tried or settled. In the context of illicit profits by insiders during an acquisition transaction, top enforcement officials at the SEC have stated that to get the evidence to prove a violation of the statute under which insider trading is alleged is very difficult.²¹ Despite the difficulties faced by regulators in prosecuting cases involving illicit profits during acquisitions, the SEC has had some success in bringing to justice some target firms and its insiders. For example, the SEC recently prosecuted a Fleet Boston executive who made \$473,000 by trading on knowledge of his bank's acquisition by Bank of America. In a settlement reached in 2004, the commission exacted \$525,000 from the executive, which included his profits, prejudgment interest of \$1,576.67 and a civil penalty of \$51,842.36 (Morgenson, 2006).

We match our sample against data in the Stanford Litigation Database and uncover several class action lawsuits involving prominent firms. For example, our sample includes the acquisition that generated a 2003 shareholder class action lawsuit against Office Max (target), Boise Cascade (acquirer), as well as executives in both companies. The complaint, which alleges violations of several rules of the SEC Act of 1934, states that “defendants were motivated to engage in fraudulent practices to collect on severance and change-in-control payments, [...] as a result, tens of millions of dollars in severance and change-in-control payments were eventually paid to defendants.” Prominent among the defendants was Michael Feuer, CEO of Office Max. The complaint alleges that Mr. Feuer obtained about \$60 million in severance and other cash payments upon closing the sale. According to our calculations, about 44 percent of the severance, or about \$26.5 million, is attributable to stock and options held by Mr. Feuer that became exercisable as a result of the acquisition. In addition to this payoff, Mr. Feuer, who retired after selling Office Max to Boise, became a consultant to Boise receiving a contract worth \$1 million a year for five years.

In Table 10, we investigate whether combined firms are more likely to be sued when the acquired firm is a rent extraction suspect. For this purpose, we run two bivariate logit regressions in which the dependent variable is “1” if the combined firm is subsequently sued for violating Rule 14d-10, Section 20A and/or other rules of the 1934 Act and is “0” otherwise. The key independent variable in the tests is our familiar rent extraction indicator. The regressions control for several target and deal characteristics as well as for industry and time effects. The results in Table 10 indicate that deals involving “change in control” agreements and severance payments to target CEOs are more likely to

²¹ The remarks are by Joseph J. Cella, chief of the office of market surveillance at the SEC, as reported by Morgenson (2006).

trigger lawsuits. Similarly, previously sued targets firms are associated with a higher probability that the combined firm is sued. The rent extraction indicator is also positive and significant. The estimate for this variable indicates that combined firms are over 6 percentage points more likely to be sued when the acquiree is a rent extraction firm. This finding suggests that acquisition deals involving rent extraction targets trigger class actions less likely to be frivolous and cases in which there is strong evidence against the defendants. This result also indicates that targets in which rent extraction is alleged are really expropriating shareholders.

V. Conclusions

Change in control clauses, prominent in CEO compensation contracts, call for sell restrictions and vesting periods on executive option awards to disappear if the firm is sold. This phenomenon provides us with the opportunity to test whether option awards granted to target CEOs prior to an acquisition are aimed at aligning the incentives of these executives with those of their firms' shareholders or aimed at expropriating shareholders.

In a sample of 364 acquisitions during 1999-2005, we identify 102 targets where CEOs' wealth from option grants increases while shareholder wealth does not. We purposely measure changes in wealth for both groups during the three years ending just after the acquisition announcement in order to include the takeover premium in the calculation. In this paper, we refer to these 102 targets as suspects of rent extraction.

Our empirical tests reveal that our suspect targets exhibit weak corporate governance structures. In addition, other tests reveal that targets where rent extraction is alleged are more likely to approach their eventual buyers to initiate the acquisition and more likely to issue their CEOs large and lucrative unscheduled option awards prior to being sold. Despite these results, we give these firms the benefit of the doubt arguing that such findings could also be consistent with incentive alignment behavior.

We provide additional evidence indicating that our suspect firms are truly engaging in rent extraction. We show that the average premium negotiated for the targets we identify as rent extraction firms is about 15 percentage points lower. We also find that these firms are more likely to issue option awards to their CEOs while the acquisition negotiation is in progress. This behavior, which appears to violate Rule 14d-10 and Section 20A of the 1934 SEC Securities Act, suggests that these targets blatantly rush to increase their CEOs option holdings in anticipation of being sold. Direct evidence on rent extraction comes from Securities laws violation related suits filed against these targets and their top executives. Indeed, we find that rent extraction targets are more likely to be sued after being acquired.

Overall, these results are opposite to the predictions of the incentive alignment hypothesis and consistent with rent extraction behavior.

The effect of rent extraction on CEO wealth is non-trivial. The top quartile of rent extraction CEOs walk away with an average \$19 million due to option grants received before the acquisition is publicly announced. This payment is in addition to other compensation from severance, golden parachutes, and lump sums CEOs get because of the acquisition. In contrast, shareholder wealth in rent extraction firms suffers a substantial decline. To provide context for these losses, we follow the procedure outlined in Moeller, Schlingemann, and Stulz (2005) and estimate that rent extraction targets experience a three-year mean abnormal dollar return loss of \$215 million.²²

Our findings on the dissimilar fate of shareholders and top managers of target firms have important public policy implications. Recently, the SEC released an amendment proposal to Rule 14d-10 of its 1934 Securities Act. The rule change would provide a safe harbor allowing the compensation committee of a target's board of directors to approve employment compensation, severance or other employee benefit arrangement for its executives during a tender offer negotiation. Our findings indicate that such rule change may have less impact than intended, since many boards are already providing generous pay arrangements for their top managers in anticipation of the eventual sale of their firms. Unfortunately, given the evidence we uncover, it appears that such compensation arrangements are provided at the target shareholders' expense.

²² This loss accrues from AY-3 to AD+1. Notably, non-rent extraction targets experience an average abnormal dollar return increase of \$375 million. As in Moeller, Schlingemann, and Stulz (2005), we calculate the abnormal dollar return multiplying the beginning period market capitalization of all targets by their abnormal return from AY-3 to AD+1, using market return as a benchmark. Our estimations rely on the S&P 500 as the market benchmark.

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Table 1

Sample Description

Our sample consists of 364 completed acquisitions announced during 1999-2005. We begin with 3,732 completed acquisitions of public U.S. target firms announced during 1999-2005 from the SDC M&A database. Next, we require that target firms have data available from the CRSP, Compustat, IRRC, and Thomson Financial's Insider Filing database. Since our study focuses on option grants prior to merger announcements, we exclude targets that do not grant options to their CEOs during the three fiscal years prior to the announcement date. Deal characteristics are obtained from SDC. There are two modes of acquisition: a merger, which is negotiated with the target managers, approved by the target's board of directors, and voted upon by the shareholders, and a tender offer, which is made directly to the target shareholders. There are three methods of payment: stock, if entire payment is in the form of acquirer stock, cash, if entire payment is in cash, and mixed, if payment includes both stock and cash. Deal attitude is classified as friendly, hostile, or ambiguous. We categorize an acquisition as related if both the target and the acquirer belong to the same Fama and French (1997) industrial classification and unrelated otherwise.

Panel A: Industrial and Temporal Distribution for Targets

Industry name	1999	2000	2001	2002	2003	2004	2005	Total	Percent
Agriculture	0	0	0	1	0	0	0	1	0.27
Food Products	0	4	2	0	0	1	0	7	1.92
Entertainment	0	0	1	0	0	3	0	4	1.10
Printing and Publishing	0	2	1	0	0	0	1	4	1.10
Consumer Goods	2	0	1	1	0	0	0	4	1.10
Apparel	0	0	0	0	0	0	1	1	0.27
Healthcare	1	0	0	0	0	1	2	4	1.10
Medical Equipment	2	3	0	0	0	2	2	9	2.47
Pharmaceutical Products	5	2	3	1	2	1	2	16	4.40
Chemicals	5	2	0	1	0	2	0	10	2.75
Rubber and Plastic Products	3	1	0	0	0	0	0	4	1.10
Textiles	0	1	0	0	0	0	0	1	0.27
Construction Materials	3	3	0	0	2	0	1	9	2.47
Construction	0	1	1	0	0	0	0	2	0.55
Steel work	2	1	0	0	0	2	0	5	1.37
Fabricated Products	1	0	0	0	0	0	0	1	0.27
Machinery	3	3	1	1	0	3	3	14	3.85
Electrical Equipment	1	1	0	0	0	0	0	2	0.55
Automobiles and Trucks	0	1	0	1	0	0	0	2	0.55
Aircraft	2	0	0	0	0	0	0	2	0.55
Shipbuilding, Railroad Equipment	3	1	1	0	0	0	0	5	1.37
Precious Metals	0	1	1	0	0	0	0	2	0.55
Non-Metallic and Industrial Mining	1	0	0	0	0	0	0	1	0.27
Petroleum and Natural Gas	1	3	6	2	1	5	2	20	5.49
Utilities	10	3	2	0	1	1	1	18	4.95
Communication	6	0	1	1	0	1	2	11	3.02
Personal Services	0	0	0	1	0	0	0	1	0.27
Business Services	9	8	7	4	7	9	12	56	15.38
Computer Hardware	5	2	2	1	0	0	3	13	3.57
Computer Software	0	2	0	0	0	0	3	5	1.37
Electronic Equipment	4	5	5	1	2	2	3	22	6.04
Measuring and Control Equipment	1	0	1	0	0	1	0	3	0.82
Business Supplies	0	4	0	0	1	1	0	6	1.65
Transportation	4	2	2	0	0	0	0	8	2.20
Wholesale	2	2	2	1	1	1	4	13	3.57
Retail	3	1	0	1	4	0	4	13	3.57
Restaurants, Hotels, Motels	2	2	1	0	0	2	0	7	1.92
Banking	3	7	3	2	5	10	5	35	9.62
Insurance	6	2	1	1	4	1	2	17	4.67
Trading	0	3	0	0	1	1	1	6	1.65
Total	90	73	45	21	31	50	54	364	100
Percent	24.73	20.05	12.36	5.77	8.52	13.74	14.84	100	

Panel B: Deal Characteristics

Mode of acquisition	<u>Merger</u>	<u>Tender Offer</u>			<u>Total</u>
	281	83			364
Method of payment	<u>Stock</u>	<u>Cash</u>	<u>Mixed</u>	<u>Unknown</u>	<u>Total</u>
	86	155	101	22	364
Attitude	<u>Friendly</u>	<u>Hostile</u>	<u>Ambiguous</u>		<u>Total</u>
	348	13	3		364
Relatedness	<u>Related</u>	<u>Unrelated</u>			<u>Total</u>
	223	141			364

Table 2
Univariate Tests: Incentive Alignment vs. Alleged Rent Extraction

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. We identify CEO's option grants from Thomson Financial's Insider Filing (TFN) using the following criteria: 1. The derivative type is OPTNS, CALL, NONQ, EMPO, DIRO, DIREO, or ISO. 2. The transaction code is A. 3. The cleanse code is R, H, or L. 4. The first (highest rank) role code is CEO. We aggregate options that have the same grant date, exercise price, and maturity date into one grant. Black-Scholes value of options (BS) is calculated using the Black-Scholes formula. Option grant date, maturity date, and exercise price are obtained from TFN. If the exercise price is missing, we use the CRSP stock price on the grant date as exercise price. Volatility is the 36 month standard deviation of CRSP stock returns before the grant date. Dividend yield is 3 year average of CRSP dividend amount divided by the stock price on the ex-distribution date (the date on which the security is first traded without the right to receive the distribution) before the grant date. Change in CEO's option pay equals $BS_{AY-1} - \text{Average}(BS_{AY-2}, BS_{AY-3})$ during the pre-SOX period (before August 29, 2002) and $\text{Average}(BS_{AY0}, BS_{AY-1}) - \text{Average}(BS_{AY-2}, BS_{AY-3})$ during the post-SOX period (after August 29, 2002). $AY-i$ denotes the i^{th} fiscal year before the acquisition announcement date. Change in shareholder wealth equals the buy-and-hold abnormal return during the period from the beginning of $AY-3$ to one day after the acquisition announcement. Buy-and-hold abnormal return ($BHAR$) is calculated following Barber and Lyon (1997) as

$$BHAR_{it} = \prod_{i=1}^{\tau} (1 + R_{it}) - \prod_{i=1}^{\tau} (1 + R_{mt})$$

where R_{it} is the stock return on day t of the sample firm and R_{mt} is the market return on day t . The market returns are measured by the CRSP value-weighted returns including dividends. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in the CEO's option compensation and zero otherwise. Last grant date is the date of the last option grant to the CEO before the acquisition announcement. $AD-10$ denotes 10 trading days before acquisition announcement date. $AD+1$ denotes one trading day after acquisition announcement date. Market value of equity and total assets are obtained from Compustat and measured at the end of the fiscal year before announcement date. Leverage equals the book value of debt divided by the sum of book value of debt and market value of equity. Governance index is constructed following Gompers, Ishii, and Metrick (2003) using the IRRC data. CEO-Chairman dummy variable equals one if the CEO is also the chairman of the board and zero otherwise. CEO tenure is the number of years the CEO had held the chief executive position in the current firm until announcement date. Golden parachute dummy variable equals one if the firm has the golden parachute as one of its antitakeover provisions and zero otherwise. Busy board dummy variable equals one if at least 50% of outside directors hold three or more directorship and zero otherwise. Hand-picked board dummy variable equals one if more than half of the outside directors join the board after the current CEO assumes the chief executive position and zero otherwise. Busy compensation committee dummy variable equals one if at least 50% of outside directors in the compensation committee hold three or more directorship and zero otherwise. Board size is the number of directors on the board. CEO stock ownership, Board stock ownership, Independent director stock ownership, Hand-picked director stock ownership, and Institutional stock ownership are the percentage of common stocks owned by the CEO, the board of directors, the independent directors, the hand-picked directors, and the institutional investors, respectively. Percent of independent directors on board is the number of independent directors divided by the board size. Percent of independent directors on compensation committee is the number of independent directors in the compensation committee divided by the size of the compensation committee. These variables are at the end of the fiscal year before acquisition announcement. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Identifying instances of potential rent extraction							
Δ in CEO's option pay	Δ in shareholders' wealth						Total
	Positive			Negative			
	Pre-SOX	Post-SOX	Total	Pre-SOX	Post-SOX	Total	
Positive	30	40	70	81	21	102	172
Negative	24	51	75	86	31	117	192
Total	54	91	145	167	52	219	364

Panel B: Mean [Median] Buy-and-hold returns for target firms				
	Full sample (<i>N</i> =364)	Rent extraction suspect?		(<i>t</i> - statistic)
		Yes (<i>N</i> =102)	No (<i>N</i> =262)	[Wilcoxon <i>Z</i>] for differences
(1) <i>BHAR</i> [AY-3, last grant date]	4.19 [-17.09]	-59.74 [-61.68]	29.17 [-3.64]	(-5.67) ^{***} [-7.87] ^{***}
(2) <i>BHAR</i> [last grant date, AD-10]	7.86 [1.79]	1.14 [-4.69]	10.46 [3.23]	(-1.60) [-1.45]
(3) <i>BHAR</i> [AD-10, AD+1]	25.37 [20.91]	34.95 [31.46]	21.81 [18.49]	(4.64) ^{***} [4.79] ^{***}
(4) <i>BHAR</i> [AY-3, AD+1]	19.15 [4.12]	-36.26 [-31.55]	40.72 [27.83]	(-6.86) ^{***} [-6.47] ^{***}
<u>Difference (2) – (1)</u>				
Δ Mean	2.27	60.75	-20.34	(4.65) ^{***}
(<i>t</i> -statistic)	(0.19)	(8.81) ^{***}	(-1.27)	
Δ Median	26.26	60.89	0.21	[6.01] ^{***}
{ <i>p</i> -value of signed rank test}	{0.00} ^{***}	{0.00} ^{***}	{0.97}	

Panel C: Mean [Median] Firm characteristics for target companies				
	Full sample (<i>N</i> =364)	Rent extraction suspect?		(<i>t</i> - statistic)
		Yes (<i>N</i> =102)	No (<i>N</i> =262)	[Wilcoxon <i>Z</i>] for differences
Market value (\$ billion)	3.297 [0.969]	2.585 [0.813]	3.575 [1.067]	(-1.23) [-1.81] [*]
Assets (\$ billion)	6.329 [1.103]	4.492 [1.045]	7.045 [1.186]	(-1.30) [-0.76]
Leverage	0.180 [0.159]	0.197 [0.171]	0.174 [0.155]	(1.25) [1.23]

Panel D: Governance characteristics of target firms						
	Rent extraction suspect?				Difference	
	Yes (<i>N</i> =102)		No (<i>N</i> =262)		<i>t</i> -stat	<i>Z</i> -stat
	Mean	Median	Mean	Median		
CEO-Chairman (0,1)	0.745	1.000	0.580	1.000	2.95 ^{***}	2.91 ^{***}
CEO age	54.706	55.000	55.477	56.000	-0.87	-1.10
CEO tenure as CEO	7.791	6.375	7.789	5.125	-0.00	0.50
CEO stock ownership (%)	1.990	0.331	2.810	0.484	-1.28	-0.70
Governance index	9.186	9.000	8.977	9.000	0.73	0.87
Board size	8.647	8.500	9.069	9.000	-1.32	-0.82
Busy board (0,1)	0.294	0.000	0.164	0.000	2.80 ^{***}	2.78 ^{***}
Hand-picked board (0,1)	0.471	0.000	0.389	0.000	1.41	1.41
Busy compensation committee (0,1)	0.345	0.000	0.240	0.000	3.13 ^{***}	3.22 ^{***}
Board stock ownership (%)	7.194	3.034	11.243	4.815	-2.71 ^{***}	-2.74 ^{***}
Institutional stock ownership (%)	21.259	20.465	22.454	19.605	-0.62	-0.26

Table 3
Option Award Patterns for Target Firms

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. The definition of the Rent extraction suspect dummy variable and the calculation of the Black-Scholes option value are described in Table 2. Following Barber and Lyon (1996), we identify a matching firm by controlling for 2-digit SIC code, total assets, and industry-adjusted return on assets (ROA) for each sample firm. The matching non-target firms are not targets in any acquisitions from year AY-3 to year AY0.

Panel A: Value of Option Awards Granted to CEOs								
Black-Scholes value of grants (in \$000)	All Targets (N=364)		Rent extraction suspect?				Difference <i>t</i> -stat <i>Z</i> -stat	
			Yes (N=102)		No (N=262)			
	Mean	Median	Mean	Median	Mean	Median		
AY-3	2,596	226	658	0	3,350	546	-5.10***	-5.79***
AY-2	2,728	490	1,097	108	3,363	699	-3.75***	-3.43***
AY-1	3,120	715	3,611	2,115	2,928	408	0.80	6.49***
AY0	4,621	981	6,727	1,622	3,926	802	1.74*	1.68*

Panel B: Size of Option Awards Granted to CEOs								
Number of shares granted (in 1,000)	All Targets (N=364)		Rent extraction suspect?				Difference <i>t</i> -stat <i>Z</i> -stat	
			Yes (N=102)		No (N=262)			
	Mean	Median	Mean	Median	Mean	Median		
AY-3	158	28	38	0	205	58	-6.70***	-6.10***
AY-2	175	50	89	17	209	78	-4.09***	-3.61***
AY-1	193	80	276	158	161	48	2.64***	6.54***
AY0	249	87	387	119	203	69	2.14**	2.07**

Panel C: Mean Value of Option Awards Granted to CEOs of Target and Matching Firms								
Black-Scholes value of grants (in \$000)	Rent extraction suspect?							
	Yes (N=102)				No (N=262)			
	Target (1)	Match (2)	(1) – (2)	<i>p</i> -value (1) – (2)	Target (1)	Match (2)	(1) – (2)	<i>p</i> -value (1) – (2)
AY-3	658	3,621	-2,963	0.163	3,350	1,867	1,483	0.105
AY-2	1,097	3,421	-2,324	0.110	3,363	2,370	993	0.319
AY-1	3,611	2,242	1,369	0.129	2,928	2,133	795	0.259
AY0	6,727	2,990	3,737	0.082	3,926	2,247	1,679	0.060

Panel D: Mean Size of Option Awards Granted to CEOs of Target and Matching Firms								
Number of shares granted (in 1,000)	Rent extraction suspect?							
	Yes (N=102)				No (N=262)			
	Target (1)	Match (2)	(1) – (2)	<i>p</i> -value (1) – (2)	Target (1)	Match (2)	(1) – (2)	<i>p</i> -value (1) – (2)
AY-3	38	361	-323	0.097	205	151	54	0.463
AY-2	89	258	-169	0.151	209	170	39	0.595
AY-1	276	129	147	0.000	161	148	13	0.691
AY0	387	211	176	0.160	203	183	20	0.650

Table 4
Incentive Alignment vs. Alleged Rent Extraction

The sample consists of 364 acquisitions announced during 1999-2005 as described in Table 1. The dependent variable is the rent extraction suspect dummy variable, which equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Busy board, Hand-picked board, Busy compensation committee, Board size, Board stock ownership, Institutional stock ownership, Independent director stock ownership, Percent of independent directors on board, and Percent of independent directors on compensation committee are defined in Table 2. CEO expected lost compensation is the estimated present value of CEOs' lost compensation when their firm is sold. To calculate the CEO's expected lost compensation, we follow the method of Fich and Shivdasani (2007), who estimate financial magnitude of personal losses of sued directors. We use information on salary, bonus, other annual compensation, long-term incentive payout, and value of restricted stock and option awards as reported in the proxy statements. First, we assume that all CEOs retire by age 70 and that CEOs in our sample who are at least 70 years old expect one year of compensation before retiring. Second, following Yermack (2004), we assume that the probability of departure increases by 4% each year due to acquisitions, delistings, or other turnover reason. Third, we assume that salary and bonus would increase by 2% from that received during the year prior to acquisition when firm performance is above the Fama and French (1997) median industry ROA. This assumption follows Bebchuk and Grinstein (2005), who report a 40% increase in salary and bonus for the period 1993-2003. Fourth, we assume that the probability of departure increases by an additional 2% when firm performance is below the median industry performance. Finally, we use a real discount rate of 3% to discount cash flows. The overconfident CEO dummy variable is defined to reflect the Malmendier and Tate (2005) long-holder measure. Following the Hall and Liebman (1998) option classification procedure, an overconfident CEO owns options at the beginning of the last year of options' life that are at least 40% in the money. We report *p*-values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable = 1 if rent extraction is suspected			
	(1)	(2)	(3)	(4)
Intercept	-3.48 (0.139)	-3.03 (0.204)	-3.37 (0.153)	-3.18 (0.181)
Governance index	0.03 (0.652)	0.03 (0.580)	0.03 (0.664)	0.03 (0.641)
CEO-Chairman (0,1)	0.70** (0.016)	0.69** (0.020)	0.77*** (0.009)	0.79*** (0.008)
CEO age	0.01 (0.695)	0.00 (0.885)	0.01 (0.737)	0.01 (0.826)
CEO tenure	0.00 (0.896)	-0.02 (0.297)	0.00 (0.839)	0.00 (0.808)
CEO stock ownership	-0.01 (0.659)	-0.01 (0.719)	-0.01 (0.675)	-0.01 (0.692)
Log(CEO expected lost compensation)	0.37** (0.028)	0.33* (0.055)	0.37** (0.031)	0.36** (0.033)
Overconfident CEO (0,1)				0.18 (0.553)
Golden parachute (0,1)	-0.14 (0.820)	-0.35 (0.579)	-0.31 (0.624)	-0.30 (0.638)
Busy board (0,1)	0.75** (0.015)			
Hand-picked board (0,1)		0.57* (0.070)		
Log(Board size)	-0.03 (0.962)	-0.08 (0.881)	-0.04 (0.939)	-0.08 (0.893)
Board stock ownership	-0.01 (0.250)	-0.01 (0.260)	-0.01 (0.264)	-0.01 (0.270)
Institutional stock ownership	-0.01 (0.511)	-0.01 (0.457)	-0.01 (0.376)	-0.01 (0.377)
Independent director ownership	0.02 (0.655)	0.02 (0.594)	0.02 (0.640)	0.02 (0.659)
Percent of independent directors on board	0.92 (0.366)	0.64 (0.543)	0.58 (0.580)	0.59 (0.572)
Percent of independent directors on compensation committee	-0.46 (0.574)	-0.35 (0.666)	-0.41 (0.617)	-0.42 (0.609)
Busy compensation committee (0,1)		1.35*** (0.003)	1.24*** (0.005)	1.23*** (0.005)
Log(Assets)	-0.34*** (0.005)	-0.32*** (0.009)	-0.33*** (0.006)	-0.33*** (0.006)
<i>N</i>	364	364	364	364
χ^2 (<i>p</i> -value)	0.01	0.00	0.00	0.00

Table 5
Probability of Deal Initiation by Targets' Management

The dependent variable equals one if the target firm initiates the deal and zero otherwise. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Target market adjusted return ($t-1$) is the market adjusted buy-and-hold abnormal return of the target firm during the year prior to initiation. Target industry adjusted ROA ($t-1$) is the industry adjusted return on assets of the target firm at the end of the fiscal year before the initiation date. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Busy board, Hand-picked board, Busy compensation committee, Board size, Board stock ownership, Percent of independent directors on board, and Percent of independent directors on compensation committee are defined in Table 2. Cash payment dummy variable equals one if the deal is paid entirely in cash and zero otherwise. Hostile takeover dummy variable equals one if the deal attitude is hostile and zero otherwise. Tender offer dummy variable equals one if the form of the deal is tender offer and zero otherwise. Relatedness dummy variable equals one if both the target and the acquirer belong to the same Fama and French (1997) industrial classification and zero otherwise. Relative size is target's market value of equity divided by acquirer's market value of equity. Book-to-market ratio equals the book value of equity divided by the market value of equity. Leverage equals the book value of debt divided by the sum of book value of debt and market value of equity. Industry acquisition activity equals the number of firms in the same Fama and French (1997) industrial classification as the target firm that are acquired during the previous fiscal year. We lose 84 observations related to non-publicly traded acquirers. This reduces our sample to 280 observations. We report p -values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable =1 if the target firm initiates the deal			
	(1)	(2)	(3)	(4)
Intercept	-3.07 (0.955)	-0.55 (0.992)	-0.68 (0.990)	-1.36 (0.980)
Rent extraction suspect (0,1)	1.05*** (0.009)	1.44*** (0.002)	1.47*** (0.001)	1.38*** (0.002)
Target market adjusted return ($t-1$)	-0.15 (0.662)	-0.35 (0.336)	-0.37 (0.319)	
Target industry adjusted ROA ($t-1$)				-1.46 (0.309)
Governance index		-0.13 (0.111)	-0.13 (0.117)	-0.11 (0.152)
CEO-Chairman (0,1)		0.12 (0.737)	0.10 (0.776)	0.13 (0.721)
CEO age		-0.01 (0.571)	-0.01 (0.652)	0.00 (0.913)
CEO tenure		0.07* (0.053)	0.06* (0.062)	0.03* (0.076)
CEO stock ownership		-0.02 (0.614)	-0.02 (0.672)	0.00 (0.889)
Golden parachute (0,1)		1.33 (0.191)	1.36 (0.184)	1.25 (0.199)
Busy board (0,1)		-0.40 (0.379)		
Hand-picked board (0,1)		-0.66 (0.160)	-0.70 (0.143)	-0.36 (0.412)
Busy compensation committee (0,1)			-0.72 (0.262)	-0.83 (0.197)
Log(Board size)		-0.49 (0.518)	-0.39 (0.608)	-0.23 (0.764)
Board stock ownership		0.01 (0.209)	0.01 (0.257)	0.01 (0.455)
Percent of independent directors on board		-0.65 (0.639)	-0.63 (0.652)	-1.34 (0.336)
Percent of independent directors on compensation committee		0.33 (0.766)	0.25 (0.827)	0.66 (0.545)
Cash payment (0,1)	-0.26 (0.559)	-0.45 (0.365)	-0.43 (0.391)	-0.14 (0.770)
Hostile takeover (0,1)	-0.72 (0.594)	-0.15 (0.916)	-0.17 (0.908)	-0.74 (0.507)
Tender offer (0,1)	-0.13 (0.811)	-0.17 (0.768)	-0.19 (0.740)	-0.31 (0.568)
Relatedness (0,1)	-0.07 (0.865)	-0.04 (0.923)	-0.08 (0.853)	-0.08 (0.845)
Relative size	0.19 (0.148)	0.24* (0.098)	0.24* (0.089)	0.23 (0.110)

Target book-to-market ratio	-1.05 (0.101)	-0.89 (0.192)	-0.96 (0.157)	-1.05 (0.126)
Acquirer book-to-market ratio	0.91 (0.138)	1.08* (0.098)	1.15* (0.079)	1.01 (0.113)
Target leverage	-2.08 (0.129)	-2.26 (0.118)	-2.27 (0.116)	-2.16 (0.133)
Acquirer leverage	1.62 (0.191)	1.93 (0.151)	1.75 (0.192)	1.69 (0.205)
Industry acquisition activity	-0.01 (0.567)	-0.01 (0.722)	-0.01 (0.689)	0.00 (0.802)
Industry effects	Yes	Yes	Yes	Yes
Year effects	Yes	Yes	Yes	Yes
<i>N</i>	280	280	280	280
χ^2 (<i>p</i> -value)	0.01	0.02	0.02	0.02

Table 6
Probability of Issuing an Unscheduled Option Grant

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. We classify a grant as a scheduled option award if it is dated within 14 days of the one-year anniversary of a prior grant. Option grants are classified as unscheduled otherwise. We run four separate regressions for each of the time intervals [AY-3, AY-2], [AY-2, AY-1], [AY-1, AD], and [ID, AD]. In each regression, the dependent variable equals one if there is at least one unscheduled grant in the corresponding time interval and zero otherwise. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Busy board, Hand-picked board, Busy compensation committee, Board size, Board stock ownership, Independent director stock ownership, and Percent of independent directors on board are defined in Table 2. Market adjusted return ($t-1$) is the market adjusted buy-and-hold abnormal return of the target firm during the year prior to each of the time intervals [AY-3, AY-2], [AY-2, AY-1], [AY-1, AD], and [ID, AD] in each regression. We report p -values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable = 1 if there is at least one unscheduled grant			
	[AY-3, AY-2] (1)	[AY-2, AY-1] (2)	[AY-1, AD] (3)	[ID, AD] (4)
Intercept	0.54 (0.781)	5.38*** (0.003)	2.64** (0.030)	-1.16 (0.458)
Rent extraction suspect (0,1)	0.71 (0.205)	0.72* (0.071)	1.09*** (0.000)	0.76** (0.017)
CEO-Chairman (0,1)	-0.12 (0.765)	0.03 (0.939)	-0.02 (0.946)	0.07 (0.838)
CEO age	0.02 (0.528)	-0.02 (0.374)	-0.02 (0.264)	-0.01 (0.585)
CEO tenure	-0.04 (0.130)	-0.02 (0.603)	0.02 (0.227)	0.01 (0.787)
CEO stock ownership	-0.03 (0.489)	0.11* (0.053)	-0.01 (0.533)	0.00 (0.935)
Busy board (0,1)	0.74 (0.242)	0.29 (0.507)	0.47 (0.131)	0.69* (0.056)
Hand-picked board (0,1)	0.07 (0.868)	-0.63 (0.119)	0.15 (0.596)	0.04 (0.912)
Log(Board size)	0.40 (0.589)	-1.37** (0.048)	-1.04*** (0.031)	0.21 (0.744)
Board stock ownership	-0.00 (0.966)	0.01 (0.210)	-0.02* (0.069)	-0.00 (0.994)
Independent director stock ownership	-0.05 (0.540)	0.09 (0.351)	0.08* (0.071)	-0.01 (0.806)
Percent of independent directors on board	0.33 (0.814)	1.85 (0.157)	-2.27** (0.017)	-1.10 (0.354)
Busy compensation committee (0,1)	0.44 (0.679)	-0.78 (0.462)	0.92 (0.201)	0.31 (0.743)
Log(Assets)	-0.20 (0.154)	-0.17 (0.190)	0.15 (0.115)	-0.06 (0.653)
Market adjusted return ($t-1$)	-0.37 (0.197)	0.03 (0.853)	0.06 (0.660)	0.09 (0.627)
N	364	364	364	364
χ^2 (p -value)	0.05	0.00	0.00	0.07

Table 7
Probability of Option Granting when Deal Negotiations are Underway

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. The dependent variable equals one if the target firm grants one or more option award to its CEO after the merger negotiation with the acquirer starts and zero otherwise. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Busy board, Hand-picked board, Busy compensation committee, Board size, Board stock ownership, Independent director stock ownership, Hand-picked director stock ownership, Percent of independent directors on board, and Percent of independent directors on compensation committee are defined in Table 2. Market adjusted return ($t-1$) is the market adjusted buy-and-hold abnormal return of the target firm during the year prior to initiation. We report p -values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable = 1 if the target firm grants one or more option award to its CEO after the merger negotiations with the acquirer starts			
	(1)	(2)	(3)	(4)
Intercept	-2.31*	-2.39*	-2.36*	-2.34*
	(0.099)	(0.089)	(0.092)	(0.096)
Rent extraction suspect (0,1)	1.26***	1.28***	1.27***	1.27***
	(0.000)	(0.000)	(0.000)	(0.000)
Governance index	-0.14	-0.15	-0.15	-0.14
	(0.270)	(0.254)	(0.257)	(0.268)
CEO-Chairman (0,1)	-0.06	-0.04	-0.04	-0.06
	(0.842)	(0.885)	(0.885)	(0.842)
CEO age	0.01	0.01	0.01	0.01
	(0.752)	(0.754)	(0.751)	(0.755)
CEO tenure	0.00	0.00	0.00	0.00
	(0.955)	(0.914)	(0.998)	(0.953)
CEO stock ownership	0.00	0.00	0.00	0.00
	(0.892)	(0.910)	(0.910)	(0.891)
Golden parachute (0,1)	0.13	0.12	0.13	0.12
	(0.841)	(0.857)	(0.841)	(0.857)
Busy board (0,1)	0.20			0.21
	(0.541)			(0.593)
Hand-picked board (0,1)		0.11		0.12
		(0.732)		(0.725)
Busy compensation committee (0,1)		0.18	0.16	0.00
		(0.704)	(0.734)	(0.998)
Log(Board size)	-0.00	-0.00	-0.00	-0.00
	(0.908)	(0.905)	(0.898)	(0.917)
Board stock ownership	-0.01	-0.00	-0.00	-0.00
	(0.940)	(0.974)	(0.960)	(0.953)
Independent director ownership	-0.04	-0.02	-0.04	-0.02
	(0.472)	(0.730)	(0.468)	(0.752)
Hand-picked director ownership		-0.05		-0.06
		(0.688)		(0.663)
Percent of independent directors on board	0.84	0.82	0.84	0.83
	(0.413)	(0.432)	(0.422)	(0.427)
Percent of independent directors on compensation committee	-0.26	-0.24	-0.25	-0.26
	(0.747)	(0.763)	(0.761)	(0.745)
Log(Assets)	0.08	0.09	0.09	0.08
	(0.431)	(0.389)	(0.389)	(0.435)
Market adjusted return ($t-1$)	0.11	0.11	0.11	0.11
	(0.531)	(0.551)	(0.551)	(0.531)
N	364	364	364	364
χ^2 (p -value)	0.01	0.02	0.02	0.03

Table 8
Negotiated Premiums Paid for Targets

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. ID, AD, and ED denote the acquisition initiation date, the acquisition announcement date, and the acquisition completion date, respectively. Buy-and-hold abnormal return (*BHAR*) is calculated following Barber and Lyon (1997) as defined in Table 2. Grant during negotiation dummy variable equals one if the target firm grants the one or more option award to its CEO after the merger negotiation with the acquirer firm starts and zero otherwise. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Busy board, Board size, Board stock ownership, Institutional stock ownership, and Independent director stock ownership are defined in Table 2. Cash payment, Hostile takeover, Tender offer, Relatedness, Relative size, and Industry acquisition activity are defined in Table 5. Market adjusted return (*t-1*) is the market adjusted buy-and-hold abnormal return during the year prior to initiation. In Panel C, we report *p*-values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Mean [Median] of abnormal returns (%)				
	Full sample (N=364)	Option granting during negotiations?		(t-statistic) [Wilcoxon Z] for differences
		Yes (N=95)	No (N=269)	
<i>BHAR</i> [ID, AD+1]	29.68 [24.33]	24.57 [22.00]	31.48 [25.70]	(-1.61) [-1.52]
<i>BHAR</i> [ID, ED]	30.19 [25.38]	25.09 [22.03]	31.99 [25.91]	(-1.53) [-1.55]

Panel B: Mean [Median] of abnormal returns of firms that grant options after initiation (%)				
	Option granting after initiation (N=95)	Rent extraction suspect?		(t-statistic) [Wilcoxon Z] for differences
		Yes (N=45)	No (N=50)	
<i>BHAR</i> [ID, AD+1]	24.57 [22.00]	20.19 [14.54]	28.52 [31.75]	(-1.13) [-1.44]
<i>BHAR</i> [ID, ED]	25.09 [22.03]	19.48 [16.98]	30.15 [33.71]	(-1.39) [-1.51]

Panel C: Multivariate analyses				
Independent variables	Dependent variable		Dependent variable	
	<i>BHAR</i> [ID, AD+1] (%)		<i>BHAR</i> [ID, ED] (%)	
	(1)	(2)	(3)	(4)
Intercept	3.83 (0.904)	6.86 (0.828)	0.06 (0.999)	-5.13 (0.877)
<i>Target's Characteristics</i>				
Grant during negotiation (0,1)	-8.85* (0.058)	0.53 (0.926)	-9.19* (0.061)	0.01 (0.998)
Rent extraction suspect (0,1)	5.19 (0.282)		5.12 (0.312)	
Grant during negotiation × Rent extraction suspect		-15.95** (0.034)		-17.42** (0.030)
Governance index	0.25 (0.776)	0.11 (0.903)	0.39 (0.678)	0.52 (0.572)
CEO-Chairman (0,1)	-7.62* (0.077)	-6.45 (0.128)	-7.70* (0.089)	-6.92 (0.121)
CEO age	0.36 (0.218)	0.16 (0.576)	0.40 (0.190)	0.36 (0.242)
CEO tenure	-0.19 (0.516)	-0.12 (0.685)	-0.19 (0.530)	-0.15 (0.610)
CEO stock ownership	0.74** (0.044)	0.74** (0.042)	0.81** (0.036)	0.84** (0.029)
Golden parachute (0,1)	9.80 (0.360)	10.01 (0.344)	13.69 (0.223)	14.86 (0.183)
Busy board (0,1)	3.64 (0.474)	6.61 (0.190)	5.31 (0.320)	7.01 (0.189)
Log(Board size)	-6.03 (0.462)	-6.04 (0.454)	-7.11 (0.408)	-8.14 (0.338)
Board stock ownership	-0.07 (0.458)	-0.09 (0.319)	-0.09 (0.333)	-0.10 (0.263)
Institutional stock ownership	0.29** (0.026)	0.31** (0.017)	0.30** (0.029)	0.31** (0.025)
Independent directors' stock ownership	0.55 (0.391)	0.61 (0.341)	0.46 (0.503)	0.54 (0.428)
<i>Deal Characteristics</i>				
Cash payment (0,1)	8.14 (0.144)	10.20* (0.061)	8.62 (0.140)	9.39 (0.105)
Hostile takeover (0,1)	-5.83 (0.637)	-7.24 (0.533)	-6.15 (0.634)	-8.14 (0.526)
Tender offer (0,1)	8.21 (0.152)	7.99 (0.158)	10.90* (0.070)	11.94** (0.047)
Relatedness (0,1)	-5.20 (0.248)	-5.40 (0.226)	-4.66 (0.324)	-4.87 (0.300)
Relative size	6.30 (0.271)	6.35 (0.261)	6.06 (0.312)	7.05 (0.238)
Industry acquisition activity	-1.44* (0.067)	-1.75** (0.026)	-1.48* (0.073)	-1.58* (0.053)
Market adjusted return (<i>t</i> -1)	0.02 (0.884)	0.04 (0.779)	0.00 (0.988)	-0.03 (0.845)
Value of interaction term and Grant during negotiation (0,1) (<i>p</i> -value of <i>F</i> -test in parentheses)		-15.42** (0.026)		-17.41** (0.011)
Industry effects	Yes	Yes	Yes	Yes
Year effects	Yes	Yes	Yes	Yes
<i>N</i>	364	364	364	364
Regression's <i>p</i> -value	0.00	0.00	0.00	0.00

Table 9
Employment for Target CEOs in the Combined Firm

The sample of 364 acquisitions announced during 1999-2005 is described in Table 1. The dependent variable equals one if the target CEO obtains a position in the combined firm after the acquisition completion date and zero otherwise. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Golden parachute, Board size, Independent director stock ownership, and Percent of independent directors on board are defined in Table 2. Cash payment, Hostile takeover, Tender offer, Relatedness, Relative size, and Industry acquisition activity are defined in Table 5. CEO on acquirer's board dummy variable equals one if the target CEO is a member of the acquirer's board of directors and zero otherwise. Target market adjusted return ($t-1$) is the market adjusted buy-and-hold abnormal return during the period from 272 to 21 trading days before announcement date. We report p -values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable = 1 if the target CEO obtains a position in the combined firm after the acquisition completion date			
	(1)	(2)	(3)	(4)
Intercept	0.33 (0.743)	-1.46 (0.244)	1.22 (0.984)	-0.96 (0.987)
<i>Targets' Characteristics</i>				
Rent extraction suspect (0,1)	-0.57** (0.023)	-0.55** (0.031)	-0.70** (0.021)	-0.68** (0.027)
Governance index	-0.01 (0.840)	-0.05 (0.312)	-0.05 (0.381)	-0.09 (0.142)
CEO-Chairman (0,1)	-0.20 (0.428)	-0.15 (0.563)	-0.29 (0.307)	-0.18 (0.527)
CEO age	0.02 (0.235)	0.01 (0.451)	0.02 (0.263)	0.02 (0.302)
CEO tenure	-0.01 (0.539)	-0.01 (0.543)	-0.02 (0.327)	-0.02 (0.333)
CEO stock ownership	-0.01 (0.456)	-0.01 (0.735)	0.00 (0.966)	0.01 (0.792)
Golden parachute (0,1)	0.40 (0.498)	0.47 (0.431)	1.08 (0.143)	1.22 (0.106)
CEO on acquirer's board (0,1)	14.55 (0.982)	14.63 (0.983)	12.82 (0.965)	13.03 (0.964)
Log(Board size)		1.20*** (0.005)		1.33** (0.019)
Board stock ownership		-0.30 (0.563)		-0.38 (0.547)
Independent director ownership		0.02 (0.658)		0.04 (0.355)
Percent of independent directors on board		-0.25 (0.743)		-0.75 (0.390)
<i>Deal Characteristics</i>				
Cash payment (0,1)	-0.39 (0.191)	-0.25 (0.412)	-0.31 (0.396)	-0.24 (0.520)
Hostile takeover (0,1)	-1.84** (0.023)	-1.81** (0.024)	-1.77** (0.049)	-1.75* (0.051)
Tender offer (0,1)	-0.46 (0.120)	-0.44 (0.139)	-0.26 (0.475)	-0.27 (0.473)
Relatedness (0,1)	-0.09 (0.715)	-0.15 (0.542)	-0.28 (0.347)	-0.26 (0.375)
Relative size	0.60 (0.143)	0.51 (0.223)	0.63 (0.190)	0.11 (0.531)
Industry acquisition activity	0.00 (0.271)	0.00 (0.244)	0.00 (0.795)	0.00 (0.823)
Target market adjusted return ($t-1$)	0.07 (0.789)	0.13 (0.613)	0.02 (0.936)	0.06 (0.703)
Industry effects	No	No	Yes	Yes
Year effects	No	No	Yes	Yes
N	364	364	364	364
χ^2 (p -value)	0.00	0.00	0.02	0.01

Table 10
Probability of Facing Shareholder Class Action Lawsuits

The dependent variable equals one if the deal is subject to shareholder class action lawsuits on allegedly violating Rule 14d-10, Section 20A and/or other rules of the 1934 SEC Security Act after the acquisition completion date and zero otherwise. All Securities Class Action Filings are obtained from the Stanford Litigation Database. Rent extraction suspect dummy variable equals one if the target firm has a negative change in shareholder wealth and a positive change in CEO option compensation and zero otherwise as defined in Table 2. Golden parachute, Executive severance, Change in control, and Supermajority voting requirement to approve a merger dummy variables equal one if the target firm has each as one of its antitakeover provisions, respectively, and zero otherwise. Governance index, CEO-Chairman, CEO tenure, CEO stock ownership, Board size, Board stock ownership, and Percent of independent directors on board are defined in Table 2. Cash payment, Hostile takeover, Tender offer, Relatedness, Relative size, Book-to-market ratio, Leverage, and Industry acquisition activity are defined in Table 5. Industry adjusted ROAs are the returns on assets adjusted by the median for firms in the same Fama and French (1997) industrial classification. Previously sued target (acquirer) dummy variable equals one if the target (acquirer) is subject to any class action lawsuit before the announcement date and zero otherwise. Delaware firm dummy variable equals one for firms incorporated in the state of Delaware and zero otherwise. Acquisition premium is the four week premium from SDC, defined as the percentage difference between the offer price and the target's stock price four weeks before announcement date. We lose 84 observations related to non-publicly traded acquirers. This reduces our sample to 280 observations. We report *p*-values in parentheses. The symbols *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Independent variables	Dependent variable = 1 if the deal is subject to shareholder lawsuits after the acquisition completion date	
	(1)	(2)
Intercept	-19.06 (0.713)	-17.29 (0.721)
Rent extraction suspect (0,1)	1.84** (0.020)	1.89** (0.017)
Governance index	-0.24 (0.156)	
Golden parachute (0,1)		-11.90 (0.906)
Executive severance (0,1)		2.30* (0.062)
Change in control (0,1)		1.88* (0.056)
Supermajority voting requirement to approve a merger (0,1)		-1.74 (0.319)
CEO-Chairman (0,1)	0.94 (0.195)	0.44 (0.584)
CEO age	0.04 (0.424)	0.00 (0.991)
CEO tenure	0.06 (0.130)	0.05 (0.218)
CEO stock ownership	0.05 (0.345)	0.06 (0.362)
Log(Board size)	0.53 (0.711)	-0.44 (0.737)
Board stock ownership	0.01 (0.747)	0.01 (0.735)
Percent of independent directors on board	2.55 (0.337)	3.71 (0.194)
Cash payment (0,1)	-1.49 (0.143)	-1.75 (0.136)
Hostile takeover (0,1)	-11.77 (0.916)	-14.45 (0.893)
Tender offer (0,1)	2.19* (0.073)	1.09 (0.410)
Relatedness (0,1)	1.38 (0.130)	1.13 (0.251)
Relative size	-0.57 (0.737)	-2.23 (0.263)
Log (Target assets)	0.37 (0.362)	0.37 (0.377)
Log (Acquirer assets)	0.25 (0.525)	0.27 (0.515)
Target book-to-market	-1.83 (0.157)	-1.22 (0.381)

Acquirer book-to-market	0.85 (0.561)	1.61 (0.310)
Target leverage	-0.16 (0.950)	-3.83 (0.183)
Acquirer leverage	-1.15 (0.608)	-2.74 (0.281)
Target industry adjusted ROA	-1.03 (0.762)	1.53 (0.677)
Acquirer industry adjusted ROA	2.60 (0.255)	0.34 (0.886)
Previously sued target (0,1)	2.39 ^{***} (0.003)	2.75 ^{***} (0.003)
Previously sued acquirer (0,1)	-0.62 (0.561)	-0.36 (0.749)
Delaware firm (0,1)	0.10 (0.887)	-0.03 (0.972)
Industry acquisition activity	0.01 (0.703)	0.00 (0.958)
Acquisition premium	-0.01 (0.366)	-0.01 (0.340)
Industry effects	Yes	Yes
Year effects	Yes	Yes
<i>N</i>	280	280
χ^2 (<i>p</i> -value)	0.01	0.01