# INCENTIVES IN MERGERS & ACQUISITIONS

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This survey reviews the literature on the role of incentives in mergers and acquisitions. We examine the incentives of the most important players in M&A decisions: acquirer and target executives, acquirer and target directors, shareholders, merger arbitrageurs, and investment bankers. We concentrate on incentives that affect the focus on value maximization, whether they be incentives to prioritize or deviate from it, and we cover financial incentives, private benefits, empire building, career concerns, and risk-reduction motives. We find a complex web of offsetting and reinforcing incentives among the decision makers, each of whom anticipates the others' incentives, and we argue that the acquisition market itself generates important incentives that discipline managers.

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## INTRODUCTION

When we set out to plan this chapter, we quickly determined that any proper synthesis of the incentives at play in mergers needed to be broad in scope, but have a clear boundary. There are many parties involved in decision-making in a merger: executives, directors, shareholders and advisors, duplicated on the bidder and target side of the transaction. Taking a broad view of the incentives at play with all of these parties could quickly become unmanageable. So, we set the boundary by concentrating on incentives that affect the focus on value maximization (whether they be incentives to prioritize or deviate from value maximization). Variation in value maximizing strategies or contracts is outside our scope.

The most obvious place to start is the compensation of the CEO considering an acquisition, and that is the focus of the first section. We continue in the subsequent sections recognizing that compensation is part of a system of interconnected forces that can substitute for or complement each other in aligning or distorting acquisition decisions. For the purposes of organizing these forces, we think of them as concentric rings around the core, which is the incentive effects of the CEO's compensation contract. The first ring includes other determinants of the acquirer manager's utility, followed by the second ring, which explores the incentives of the other deal participants (target managers, directors of both the bidder and target, shareholders, arbitrageurs, and investment bankers). The third ring moves to non-compensation governance solutions to agency problems, such as board oversight and shareholder voting, and the final ring discusses the important role of the takeover market as an incentive device that disciplines managers.

In the compensation section, we examine how doing an acquisition affects CEO pay and wealth, and how this affects CEOs' incentives. A consistent finding is that many acquirer CEOs do not suffer the value consequences of bad acquisitions. While the value of their equity holdings declines, this is in many cases more than offset by pay increases, new equity grants, and M&A bonuses. This increases CEOs' incentives to acquire and weakens their incentives to avoid bad deals.

As we move to the first ring—other determinants of the acquirer manager's utility—we expand beyond short-term payments and consider career and labor market (both managerial and directorial) incentives, private benefits of control and empire building, and personal risk reduction. This section highlights the fact that a CEO's expected utility from an acquisition is affected by many considerations beyond immediate monetary payoffs. The desire to continue being a CEO of a company, with its private benefits of control, rewards for acquisition experience in the director labor market, and reducing one's risk exposure by diversifying the firm, can all lead to acquisitiveness.

In the second ring, we pivot from acquiring managers to focus on the other deal participants. Target managers have their own incentives, often to resist a deal, and those incentives are important both contingent on an offer, but also in the acquirer's calculus of whether to propose a deal in the first place. Nominally, the decision makers are the two boards of directors, and those directors have incentives that differ from both those of their CEOs and of the shareholders they represent. Finally, there are financial intermediary parties in mergers—risk arbitrageurs and investment banking advisors—with financial incentives that differ from those of target and acquirer shareholders. We detail in this section how each party can have incentives that differ from maximizing firm value, whether due to personal career incentives, or from heterogeneously experienced externalities from the merger. These incentives shape the design and outcome of a bid directly, and they impact the incentives of the bidder to propose a transaction in the first place.

In our third ring, we turn to a discussion of the governance mechanisms that restrain the incentives of deal participants to deviate from value maximization. These governance mechanisms function through monitoring by the board, shareholders, creditors, and analysts. Since we covered incentive problems of both the board and shareholders in the prior section, in this section we highlight the complex relationship between the incentives of directors and some shareholders to deviate from value maximization, and the expectation that they will monitor and discipline other decision-making agents in the merger transaction.

In our fourth and final ring, we discuss the incentives generated by the takeover market itself, continuing our theme that the web of incentives is complex and multifaceted. We argue that the very incentives of CEOs to acquire, serve to discipline other CEOs' acquisitive incentives. Because poor performance, including that brought on by bad acquisitions, can lead to a disciplining takeover and turnover for both the CEO and board, an active takeover market results in tighter internal monitoring of investment decisions.

In our final section, we conclude and offer some ideas for future research. Despite challenges, the literature has significantly improved our understanding of each of the myriad incentive forces impacting the merger and acquisition market. What is largely missing are studies of how these incentives interact with each other in a complex web of offsetting and reinforcing forces, with each decision maker recognizing the other players' incentives. Figure 1 summarizes the parties, the forces impacting their incentives, and some of the interactions at play, discussed in this chapter.

While our chapter emphasizes incentives that cause managers and others to deviate from firm-value maximization, it is important to recognize that the M&A market creates a large number of value-improving business combinations. Thousands of acquisitions occur every year, despite target CEOs suffering career setbacks in many of them, and combined firm value increases in most of them. Thus, incentives for value creation or governance oversight are working in many cases. At the same time, the evidence also shows that misaligned incentives are a serious problem – there is large heterogeneity in value creation across deals, acquirer shareholders suffer losses in a significant number of them, and the evidence suggests that many offers are never made because of expected resistance by the target.

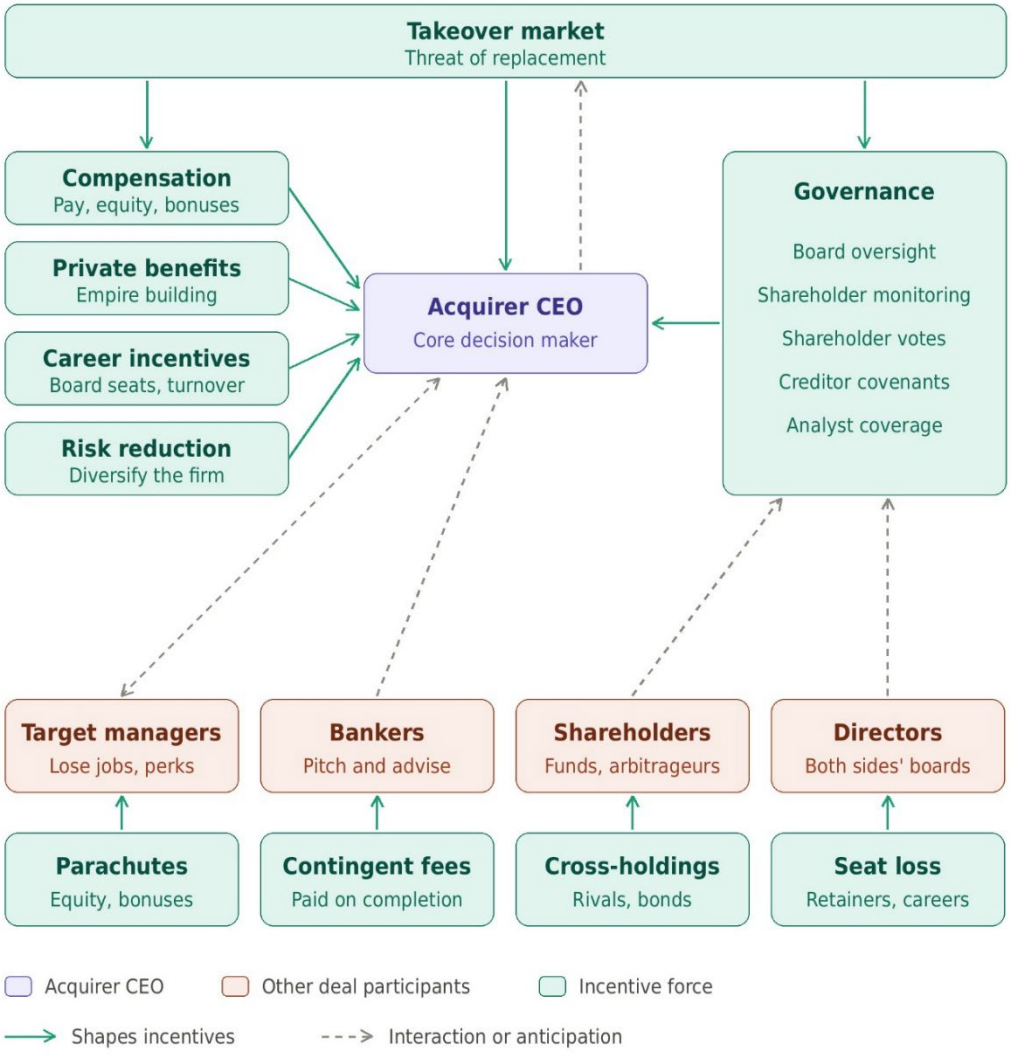



Figure 1: Parties to a merger and forces impacting their incentives

## 1 THE CORE: COMPENSATION

In this section, we discuss how executive compensation shapes the incentives of a CEO who is considering an acquisition. We focus on the CEO's current compensation contract and expectations of near-term changes in compensation; we leave long-run career and labor market considerations to the next section.

A caveat is that most of the studies discussed in this section document correlations between CEO pay and acquisition activity, which may differ from causal effects. Compensation contracts are the endogenous outcome of a complex bargaining process between the CEO and the board. They are correlated with observable and unobservable firm and CEO characteristics, such as growth opportunities, governance quality, and CEO ability, many of which also affect acquisition decisions. Consequently, any observed correlation between CEO pay and acquisition choices is unlikely to capture the true causal relationship. CEO pay and acquisition decisions may be correlated because pay incentives affect acquisitions, because CEO pay is set in anticipation of acquisition activity, or because an unobserved firm or CEO characteristic affects both.

### 1.1 CEO pay and firm scale

Firm size and the level of CEO pay are strongly positively correlated, both in the cross-section and over time (Roberts, 1956; Baker, Jensen, and Murphy, 1988). One explanation is that larger firms hire better and therefore also more expensive CEOs (see, for example, Rosen (1982) and Gabaix and Landier (2008)). The size-pay relationship might be reinforced by mechanical benchmarking, with firms and compensation consultants deducing the appropriate level of CEO pay from other firms of similar size (Bizjak, Lemmon, and Naveen, 2008; Jochem, Ormazabal, and Rajamani, 2026). Size-based benchmarking might create an incentive for CEOs to grow their firm in order to increase their pay, even if doing so does not benefit shareholders.

Many studies have shown that CEO pay tends to increase after acquisitions (Lambert and Larcker, 1987; Firth, 1991; Khorana and Zenner, 1998; Bliss and Rosen, 2001; Grinstein and Hribar, 2004; Girma, Thompson, and Wright, 2006; Harford and Li, 2007; Guest, 2009; Ozkan, 2012; Yim, 2013; Bargeron and Denis, 2026). Several studies also show larger pay increases after deals with positive acquirer stock price reactions than after deals with negative reactions. Increased CEO pay may reflect rent extraction, compensation for effort, or efficient recontracting because the acquisition changes the scale, complexity, or risk profile of the firm.[1]

A more important question is how acquisitions affect overall CEO wealth. Most CEOs have sizeable holdings of company stock and options, whose values fall if an acquisition reduces shareholder value. For value-reducing acquisitions to not decrease CEO wealth, the (capitalized) increase in CEO pay has to fully compensate for the losses on the CEO's equity holdings.

Lambert and Larcker (1987) find large CEO wealth increases for acquisitions with positive acquirer announcement returns, but only small CEO wealth losses for deals with negative announcement returns. Firth (1991), using UK data, observes small CEO wealth increases even for deals with negative stock price reactions. Bliss and Rosen (2001), focusing on bank mergers, show that 77% of acquirer CEOs experience a wealth increase, even though most deals create negative stock price reactions.

Harford and Li (2007) provide the clearest evidence that acquisitions decouple CEO and shareholder wealth because CEOs receive new stock and option grants after completing deals. In deals followed by poor stock price performance, these grants offset the loss on the CEO's stock and option holdings, rendering CEO wealth insensitive to poor performance. CEO wealth remains sensitive to good post-acquisition performance. CEOs with below-

[1] For example, Bargeron and Denis (2026) show that the increase in CEO pay is largest for all-stock deals, and that the increase comes almost entirely in the form of equity-based pay. They interpret this as acquirer CEOs signalling to target shareholders that the acquirer stock is not overvalued.

median tenure, who are likely to have less power vis-à-vis their boards, have more downside exposure, which suggests that the asymmetry may not be explained by optimal risk sharing.

In sum, the evidence suggests that most CEOs do not internalize the shareholder value consequences of bad acquisitions even though most CEOs have substantial equity holdings. While the value of their company stock and options falls with share prices, firms compensate with pay increases, new equity grants and, as we will discuss in the next section, M&A bonuses.[2] Independently of whether this is ex-post optimal, it weakens the disciplinary effect of CEO equity ownership, it increases CEOs' incentive to undertake acquisitions, and it weakens their incentive to avoid value-reducing deals.

Lan and Pan (2026) conduct an interesting test of the hypothesis that top executives' desire for higher pay motivates acquisitions. In 2014, the Chinese government capped the total pay of top executives of certain state-owned enterprises (SOEs) at 10.4 times the average salary of the company's employees. This led to large declines in top executive pay, especially for CEOs, and it weakened the pay-size relationship. Afterwards, the acquisition activity of treated SOEs declined significantly relative to unaffected non-SOEs. While it is difficult to generalize from Chinese SOEs, the results suggest that at least some acquisitions are driven by top executives' desire to increase their pay.[3]

### 1.2 M&A bonuses and size-linked incentive pay

CEO compensation often directly rewards acquisitions. In Grinstein and Hribar's (2004) sample of large U.S. transactions, 39% of acquirers report that deal completion is a reason for paying their CEO more, typically through a cash bonus. The size of the M&A bonus is positively related to measures of effort, such as deal size and time to completion, but unrelated to measures of performance, such as acquirer announcement returns or

[2] Fich, Starks, and Yore (2014) observe that CEOs are also financially rewarded for other types of deal making activity (joint ventures, strategic alliances, seasoned equity offerings, and spin-offs), including for deals that cause negative stock price reactions.

[3] Yim (2013) provides suggestive evidence for the US: pay increases following acquisitions are long lasting and younger CEOs, who can expect to benefit for longer, undertake more acquisitions than older CEOs.

premiums. Among firms providing explanations for M&A bonuses, increases in firm size and revenues are most frequently cited; value creation is mentioned much less. Finally, measures of CEO power (chairman, sitting on the nominating committee) are positively related to the size of the bonus and to the size of the deal, and negatively to acquirer announcement returns. This suggests managerial power, rather than incentive alignment, as one driver of M&A bonuses.

While it is clear that M&A bonuses create incentives to do deals, Bakke, Kronlund, Mahmudi, and Virani (2025) note that more than one-third of US public firms use performance-linked executive pay that explicitly ties payouts to firm size. The size metric is almost always revenue, and payouts take the form of stock or cash. While the size metric could be adjusted to exclude inorganic growth, almost no firms do so. Consequently, executives can use acquisitions to meet their size targets.

Bakke et al. show that firms with such "growth incentives" have a 25% higher probability of doing an acquisition in a given year, that the deals are often of a size that allows executives to reach their size targets, and that their deals are associated with lower acquirer announcement returns. The study provides several pieces of evidence suggesting that size-linked incentive pay causes executives to do more deals. For example, when exchange rate movements increase revenues for exporting firms, so executives no longer need acquisitions to reach their targets, growth incentives are no longer associated with increased deal activity.

In sum, many firms provide pay incentives to their top executives that encourage acquisitions. In the case of M&A bonuses, this is clearly intentional. In the case of incentive pay tied to firm size, the effect on acquisition activity could be unintentional. However, boards could easily exclude inorganic growth from size metrics, boards approve M&A deals, and boards should note when size targets are met only because of acquisitions. Thus, it seems likely that boards want size-linked incentive pay to encourage acquisitions.

### 1.3 Equity-based pay and equity holdings

A large literature examines whether top executives' equity-based pay and equity holdings are correlated with the quantity and quality of M&A activity. The importance of equity pay for CEOs and other top executives has increased over time. Until the 1970s, top executive pay comprised mainly salaries and annual bonuses (Frydman and Saks, 2010). During the 1980s and especially the 1990s, options surged to become the largest component of top executive pay. For example, for S&P 500 CEOs, options increased from 19% of pay in 1992 to 49% by 2000. (Edmans, Gabaix, and Jenter, 2017) During the 2000s, options declined and performance-vesting stock became the dominant form of equity-based pay (Bettis, Bizjak, Coles, and Kalpathy 2018), which it is still today.

Datta, Iskandar, and Raman (2001) analyze acquisitions from 1993–1998 and find a positive association between acquirer top executives' option compensation and announcement returns and stock price performance over the subsequent three years. Executives for whom options are a larger fraction of their compensation pay lower premiums, acquire targets with more growth opportunities, and see greater increases in stock price volatility after deals, consistent with more risky acquisitions. Datta et al. interpret this as option compensation incentivizing managers to act in the interests of shareholders.

While Datta et al. focus on the flow of option compensation, most top executives have substantial stock or option holdings in their employer, which directly tie their wealth to its stock price performance (Hall and Liebman, 1998). Any measure of executive incentives should include the incentives provided by changes in the value of executives' equity holdings. Ideally, it would measure how an executive's overall wealth changes with shareholder value.

The literature has settled on two complementary measures of executives' wealth-performance sensitivity. One is the "effective percentage ownership", which measures the

executive's change in wealth for a $100 increase in shareholder value.[4] For example, a CEO who owns 2% of their firm's equity gains $2 for each $100 increase in shareholder value. The second measure is the effective dollar ownership, which measures the executive's change in wealth for a percentage change in shareholder value.[5] For example, a CEO with an effective dollar ownership of $20 million gains $200,000 for each 1% increase in shareholder value.

Both measures of equity incentives are important. Which measure to use depends on how the executive's actions affect firm value. If the effect is additive, so executive actions have the same dollar value regardless of firm size, the effective percentage ownership is the right measure of incentives. For example, the cost to an executive of overpaying for an acquisition by $100 million depends on their percentage ownership. If the effect of the executive's actions is multiplicative, their impact on value scales with firm size, and effective dollar ownership is the right measure of incentives. For example, the cost to an executive of a bad merger that lowers shareholder value by 10% depends on their dollar ownership.

For US top executives, their effective dollar ownership tends to be large and their effective percentage ownership small. In 2014, the median S&P 500 CEO had an effective dollar ownership of $67 million but an effective percentage ownership of only 0.34% (Edmans, Gabaix, and Jenter, 2017). Thus, if this CEO makes a bad strategic decision that lowers shareholder value by 10%, they lose $6.7 million. If the same CEO overpays for a deal by $100 million, they lose only $0.34 million. This suggests that most CEOs are well motivated to get major strategic decisions right, but that they may also decide to waste money on pet projects. Direct monitoring by boards or shareholders (discussed in Section 4), rather than equity incentives, is likely to be the only practically feasible way to rein in the latter.

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[4] The effective percentage ownership is typically calculated as (*number of shares owned* + $\sum_i \delta_i \cdot$ *number of options in grant* $i$) / (*number of shares outstanding*), where the sum is over the option grants held by the executive and $\delta_i$ is the option delta for grant $i$.

[5] The effective dollar ownership is typically calculated as (*number of shared owned · stock price + Black-Scholes value of options owned*). Some studies approximate it as the effective percentage ownership times the firm's equity market capitalization.

Turning to the literature, we start with studies that link equity incentives to acquirer stock returns. Lewellen, Loderer, and Rosenfeld (1985) find that the abnormal returns earned by acquirer shareholders from bid announcement to shareholder approval are positively correlated with the percentage of stock held by the acquirer's senior management. Results are similar but weaker for dollar ownership. Minnick, Unal, and Yang (2011), who look at acquisitions by bank holding companies, find that the CEO's effective dollar ownership is positively correlated with acquirer announcement returns and with accounting and stock return performance over the subsequent three years.

In contrast, Petry and Settle (1991) find no relation between top executives' percentage or dollar equity ownership and acquirer stock returns from 20 days before to 100 days after acquisition announcements. Masulis, Wang, and Xie (2007) also find acquirer announcement returns to be unrelated to the fraction of annual CEO pay that is in equity and to the CEO's effective dollar ownership. Finally, Boulton, Braga-Alves, and Schlingemann (2014) find acquirer announcement returns to even be negatively related to the CEO's equity exposure,[6] even though this correlation becomes insignificant when they control for firm and deal characteristics. Thus, the evidence on the correlation between top executives' equity incentives and acquirer stock returns is contradictory.

A difficulty with interpreting studies linking executive ownership to acquirer announcement returns is that announcement returns are not necessarily a reliable measure of value creation. Ben-David, Bhattacharya, Huang, and Jacobs (2026) show that announcement returns do not correlate with several measures of ex post outcomes. They argue that the stock price reactions to deal announcements are dominated by information about the value of the stand-alone acquirer, which makes it hard to extract investors' assessment of the deal.

Other studies link managers' equity incentives to the probability of making an acquisition and to the type of acquisition made. Cai and Vijh (2007) find that CEOs with higher dollar

[6] They measure equity exposure as 0.01 times the effective dollar ownership divided by the sum of 0.01 times effective dollar ownership, annual salary, and annual bonus.

ownership make more acquisitions, pay higher premiums, close deals faster, and are more likely to make diversifying acquisitions and pay with equity. Percentage ownership gives qualitatively similar but less significant results. Bargeron, Schlingemann, Stulz, and Zutter (2008) show that public firms with low managerial percentage ownership pay higher premiums than public firms with high managerial ownership and private firms. Boulton, Braga-Alves, and Schlingemann (2014) find a positive correlation between their measure of CEO equity exposure and acquisitiveness, acquisition size, the use of equity as payment, and the propensity to acquire private firms.

Another set of studies focuses on how top managers' equity exposure affects their risk-taking incentives, which might in turn affect whether and what type of acquisitions they make. Empirically, most acquisitions appear to increase firm risk, in the sense that stock return volatility and default probabilities are higher after a deal than before (Furfine and Rosen, 2011; Croci and Petmezas, 2015).

Theory suggests that greater stock holdings, by increasing the exposure of executive wealth to firm value, make risk-averse executives less willing to increase firm risk.[7] The effect of stock options, however, is ambiguous. Options might reduce managers' aversion to risky investments by making the relationship between managers' wealth and firm value convex (Smith and Stulz 1985). Intuitively, since the expected value of stock options increases in stock price volatility, an executive with options might prefer higher volatility. However, as Carpenter (2000), Ross (2004), and Lewellen (2005) point out, the effect of options on risk-taking incentives is complex. Options increase the sensitivity of executive wealth to changes in stock prices, which reduces risk-taking incentives, but they also increase expected wealth and make the relationship between stock prices and wealth convex, which increases risk-taking incentives. The net effect is an empirical question.

In an early contribution, Agrawal and Mandelker (1987) observe that the top executives of firms that undertake volatility-increasing acquisitions have larger dollar (but not

[7] In a levered firm, equity is a call option on firm value, so the value of equity increases in the variability of firm value. However, unless leverage is very high, this effect is small (Guay 1999).

percentage) equity ownership than top executives that do volatility-decreasing deals.[8] Since executive options were uncommon during their 1974–82 sample period, this result is unexpected.

Later studies distinguish between stock and option holdings. Following the methodology of Core and Guay (2002), they estimate the sensitivity of the value of executives' stock and option portfolio to the stock price ("delta") and its sensitivity to stock price volatility ("vega").[9] Hagendorff and Vallascas (2011) analyze acquisitions by banks and find that higher CEO vega is associated with larger increases in default risk (measured as Merton's distance-to-default) from before to after deals. Higher delta, in contrast, is associated with reductions in default risk. Croci and Petmezas (2015) find that higher CEO delta and vega are associated with more acquisitions, but the association is stronger for vega. Both delta and vega are also associated with more volatility-increasing acquisitions, large acquisitions, and acquisitions of private targets.

In sum, CEOs' and other top executives' equity ownership is positively correlated with acquisition activity and with doing larger and possibly also riskier deals. There is no consistent correlation between equity ownership and the stock returns earned by acquirer shareholders. Interpreting these correlations is difficult. While theory suggests that equity incentives should affect top executives' effort and willingness to take risk, executives' equity exposure is the outcome of a complex set of decisions by firms and executives. Consequently, executives' equity exposure is likely to be correlated with unobserved firm and executive characteristics, such as investment opportunities, strategy, and competitive position, many of which affect acquisition activity.

## 1.4 Other compensation incentives

### *1.4.1 Inside debt*

[8] They scale dollar ownership by annual compensation, which complicates the interpretation.
[9] An executive's combined stock and option delta is proportional to their effective dollar ownership, making the two measures equivalent.

The idea of "inside debt" – executive pension and deferred compensation claims that expose executives to their firm's default risk and therefore make part of executive wealth resemble a creditor claim – was developed by Jensen and Meckling (1976), Sundaram and Yermack (2007), and Edmans and Liu (2011). Inside debt's incentive effects are almost the reverse of those of options – options increase executives' exposure to the upside, while inside debt increases their exposure to default.

Phan (2014) examines the role of CEO inside debt in acquisitions and finds it to be negatively related to risk taking: CEOs with high inside debt undertake fewer acquisitions, choose industry-diversifying deals, use less leverage and cash, and have smaller post-deal increases in firm risk. Higher CEO inside debt is also linked to lower deal announcement returns for shareholders, higher announcement returns for bondholders, and better long-run post-deal operating performance. Srivastav, Armitage, Hagendorff, and King (2018) find consistent evidence in a sample of acquisitions by banks: higher CEO inside debt is associated with lower announcement returns for shareholders, higher announcement returns for bondholders, and declines in stock and bond volatility from before to after the deal. Finally, Lin, Officer, and Shen (2018) show that vertical (but not horizontal or diversifying) acquisitions are associated with declines in firm risk, that higher CEO inside debt is associated with more vertical deals, and that vertical deals by CEOs with higher inside debt earn lower shareholder announcement returns. These patterns are consistent with inside debt reducing CEOs' risk taking and aligning their incentives with creditors rather than shareholders.

### *1.4.2 EPS-linked compensation*

Earnings per share (EPS) is the most popular accounting-based performance metric in both annual bonus plans and long-term incentive plans (Cheng, Harford and Zhang, 2015; Bennett, Bettis, Gopalan, and Milbourn, 2017). The use of EPS in incentive plans has been criticized for causing managers to act short-terminist, for example by cutting R&D or undertaking opportunistic share repurchases (Almeida, 2019).

Dasgupta, Harford, and Ma (2019)[10] examine whether the use of EPS in incentive plans is related to how acquisition deals are structured. Incentives are measured as the value of CEO's unvested incentive plans for which EPS is a performance metric. Dasgupta et al. find that more EPS-linked pay predicts greater use of cash as payment method, which avoids EPS dilution from issuing shares. In a sample of stock and mixed deals, greater EPS-linked pay predicts a higher probability that the deal is EPS-accretive. Notably, compensation tied to total earnings (e.g., net income, EBIT, or EBITDA) does not have the same predictive ability. These results suggest that using EPS in incentive plans distorts how acquisition deals are structured.[11]

### *1.4.3 Relative performance evaluation*

The use of relative performance evaluation (RPE) in executive compensation contracts is widespread (Gong, Li, and Shin, 2011; Bettis, Bizjak, Coles, and Kalpathy, 2018). Holmstrom (1979) shows that any signal that is incrementally informative about an executive's effort should be included in their contract. This implies that signals correlated with performance but unrelated to the CEO's actions, such as shocks to the industry or economy, should be used to remove noise and improve the informativeness of the performance measure. In practice, this typically means measuring firm performance relative to that of similar firms in the same industry that are, hopefully, exposed to the same shocks.

Few papers have tried to link the use of RPE in executive pay to acquisition behavior. Wruck and Wu (2022) examine firms that switch from not using RPE incentive plans for their CEOs to using them, or vice versa. For firms that switch to using RPE plans, they find that the correlation between firm stock returns and industry index returns falls and firm idiosyncratic risk increases. Looking at acquisitions, they find that firms that switch to RPE subsequently

[10] The published version of the same paper, Dasgupta, Harford, and Ma (2024), no longer has the analysis of EPS-linked CEO compensation.

[11] It is an open question whether CEO's focus on EPS also affects which acquisitions are done. Garvey, Milbourn, and Xie (2013) provide suggestive evidence that a firm is more likely to become a target when other firms in the same industry could acquire it in a stock deal that is EPS-accretive to the buyer even after paying a substantial premium.

acquire targets in industries outside their primary SIC code, while a switch to absolute performance evaluation is followed by more within-industry acquisitions. This is consistent with CEOs who face RPE trying to deviate from their performance benchmark. Looking at acquisition performance, An, Liu, Tan, and Wu (2024) find that the use of RPE plans for any top executive is associated with lower acquisition announcement returns but higher abnormal stock returns over the subsequent 12 to 36 months. The causal mechanism is, however, unclear.

### *1.4.4 Compensation horizon*

Both the time horizon over which incentive plans measure performance and the length of the vesting period of any equity instruments granted after the measurement period should affect how long-termist executives are in their decision making. In an early contribution, Tehranian, Travlos, and Waegelein (1987) connect the presence of long-term incentive plans for top executives to acquisition announcement returns and changes in profitability. During their sample, long-term incentive plans were typically based on accounting performance, most often EPS, over a three-to-five-year period. They find that acquirers with long-term incentive plans earn higher announcement returns and experience larger increases in EPS from before to several years after the deal.

Li and Peng (2021) relate a measure of executive "pay duration", which is a weighted average of the vesting periods of different pay components and quantifies how long-term compensation is, to acquisition decisions.[12] CEO pay duration positively correlates with firms' propensity to make an acquisition in the next year. However, the stock market reacts more negatively to acquisitions by CEOs with above median pay duration. There is no difference in target announcement returns or takeover premiums, suggesting that investors worry about deal quality rather than wealth transfers. In the three years after a deal, acquisitions by CEOs with above median pay duration are followed by a decline in ROA and

[12] This measure of pay duration was first developed by Gopalan, Milbourn, Song, and Thakor (2014).

lower abnormal stock returns relative to peer firms. The negative relation between pay duration and post-deal performance is driven by time-vesting pay, while the duration of performance-vesting pay appears to have no effect. The causal link between the duration of time-vesting pay and worse acquisitions is unclear, and the correlation might be due to an omitted variable. For example, a board might grant long-duration time-vesting equity in expectation of a difficult post-deal integration.

### *1.4.5 D&O insurance*

Many firms purchase directors' and officers' (D&O) liability insurance, which covers the costs executives incur when defending or settling lawsuits brought against them as a result of their work in the firm. D&O insurance may pay an executive directly, or it may reimburse the firm if the firm has indemnified or defended its executive.

Lin, Officer, and Zou (2011) manually collect the D&O insurance purchases of Canadian firms and link them to acquisition outcomes.[13] They find that acquirers with higher levels of D&O insurance earn lower announcement returns, pay higher premiums, undertake acquisitions with lower synergies, and achieve worse post-deal operating performance. Lin et al. interpret this as D&O insurance creating moral hazard by shielding directors and officers from shareholder litigation.

A challenge for this interpretation is that the effect of D&O insurance on the litigation exposure of most executives should be small. Most firms indemnify their executives against the cost of most lawsuits, which makes D&O insurance redundant from the perspective of executives. Even though firms typically cannot indemnify executives if they are found to have breached their fiduciary duty or if the firm is insolvent, both are rare circumstances. Thus, it is not clear why D&O insurance should have first-order effects on executive behavior. Alternatively, firms might purchase high levels of D&O insurance when they expect managers

[13] Unlike Canadian firms, US firms (except those based in New York) do not have to disclose D&O insurance purchases (Chalmers, Dann, and Harford 2002).

and directors to take decisions, such as bad acquisitions, that are likely to attract shareholder lawsuits.

## 1.5 Summary

Many studies examine the pay of top executives in acquirers. The most striking finding is that many acquirer CEOs do not internalize the value consequences of bad acquisitions. While the value of their company equity declines in a bad deal, firms offset these losses through pay increases, new equity grants, and M&A bonuses. This should increase CEOs' incentive to do acquisitions, and it weakens their incentive to avoid value-reducing deals.

Even more studies correlate aspects of executive pay and equity ownership with acquisition behavior and performance. For example, more equity exposure by top executives is associated with more acquisitions, more inside debt is associated with lower shareholder and higher bondholder announcement returns, and EPS-linked incentive plans are associated with the use of cash as payment method. However, establishing causality remains a challenge. For example, equity ownership might motivate executives to do more acquisitions, firms that plan acquisitions might grant more equity to align incentives, or both equity ownership and acquisitions might be driven by an underlying firm fundamental. Establishing causality would require assigning equity ownership (as good as) randomly to executives, which is infeasible.

## 2 THE FIRST RING: OTHER INCENTIVES FOR ACQUIRING CEOS

In this section we move beyond incentives directly related to near-term compensation and discuss incentives driven by career and labor market considerations, private benefits and empire building, and personal risk-reduction.

### 2.1 Private Benefits and Empire Building

There are many private benefits of being the CEO of a company, and preservation or expansion of those benefits provides significant incentives to acquire. Jensen (1986) famously made the point that managers have incentives to cause their firm to grow, often through acquisition, beyond its optimal size. This may be because compensation increases with firm size (see Section 1), or because managers enjoy the prestige and perquisites associated with running a larger firm.

Two papers model specific drivers of that incentive to grow: Shleifer and Vishny (1989) assume that by having the firm make investments that are specific to their skill set, managers can increase the cost to shareholders of replacing them. Such manager-specific acquisitions will increase CEO bargaining power, allowing them to extract higher wages and larger perquisites. Gorton, Kahl and Rosen (2009) show that when managers anticipate a period of consolidation in their industry (i.e. a merger wave), medium-sized firms have an incentive to acquire to decrease their feasibility as a target, thus allowing managers to remain in control and maintain their private benefits. They present empirical evidence consistent with their "eat-or-be-eaten" hypothesis. In a purely empirical study, Phalippou, Xu, and Zhao (2015) examine acquisitions of companies that have been highly acquisitive themselves. They show that buying acquisitive targets produces a disproportionate share of negative announcement returns, and they argue that the motivation for acquiring them is defensive, consistent with Gorton, et al.'s (2009) hypothesis. Collectively, these papers suggest that at least some acquisitions are motivated by an incumbent CEO's desire to maintain their position.

Managers who care about status and prestige might want to be CEO of a Fortune 500 company, which also has potential career benefits. Meneghetti and Williams (2017) show that as firms approach the Fortune 500 cutoff from below, they become abnormally acquisitive, and seek out larger targets, for which they are willing to pay higher premia. Shareholders recognize the motivation for these acquisitions, as evidenced by the more negative reaction to acquisitions made by companies close to the cutoff. Nonetheless, such acquisitions driven by personal incentives are an example of how imperfect control of these agency conflicts contributes to acquisition activity.

Continuing the theme of agency problems, Harford, Humphery-Jenner, and Powell (2012) study the acquisitions of entrenched managers and find that they tend to overpay and select low-synergy targets, while avoiding situations where they would acquire a monitoring blockholder (e.g. through paying in stock for a firm with an existing large stockholder). Thus, not only do they tend to make worse acquisitions, but when they acquire, they structure the deal to preserve their entrenchment.

The overall take from this set of research is that, by revealed preference, managers get substantial utility from remaining as CEO of a company—particularly a large, prominent one—and the incentive to maintain that position causes them to take actions, even value-destructive ones, to preserve it. This is well understood on the target side, where target CEOs resist bids to preserve their control of the firm (see Section 3.1). However, as the evidence in this section shows, the same motivation on the bidder side can cause value-reducing acquisitions to go ahead.

## 2.2 Career Incentives

Career incentives—both as a manager and later as an outside director of other firms—might be expected to offer some form of settling-up for bad acquisitions. Here the evidence is mixed. As discussed in Section 1, firm size is a major determinant of CEO pay (Roberts, 1956; Baker, Jensen, and Murphy, 1988). However, a CEO must remain employed to collect that higher pay. Lehn and Zhao (2006) find that almost half of acquiring firm CEOs are

replaced with in 5 years of the acquisition. About a quarter of acquiring CEOs are replaced due to board action, and about one in six lose their job due to the firm being acquired itself (the rest are due to bankruptcy). Notably, they show that turnover is much more likely after a value-destroying acquisition, allowing them to conclude that there is some ex-post settling-up incentive acting on CEOs to make better acquisition decisions. Consistent with this, Jacobsen (2014) examines bidders' willingness to walk away during the bargaining phase and finds that bidder CEOs who refuse to increase the offer price are not only less likely to be replaced, but are more likely to become CEO of a larger firm.

The desire to be hired as the CEO of a larger (or at least better-paying) firm might affect CEOs' acquisition incentives more broadly. Coles, Li, and Wang (2018) propose to measure a CEO's external promotion incentives by the pay differential between the CEO and the highest-paid CEOs within the same industry. The idea is that a larger pay gap to the highest-paid CEOs, which Coles et al. call "industry tournament incentives", motivates CEOs to work harder, but also potentially to take more risk.

Qin and Huang (2024) apply the Coles et al. measure to acquisitions. They find that deals led by CEOs with stronger industry tournament incentives earn higher abnormal announcement returns. This relationship is stronger for CEOs below retirement age, in industries with an above-average number of firms, and in industries with an above-average number of CEO turnovers, consistent with stronger external promotion incentives. No study has examined the relationship between industry tournament incentives and the frequency or type of acquisitions in general.[14]

A challenge for interpreting the Coles et al. measure as external promotion incentives is that few CEOs become CEOs at other firms in the same industry (Barry, Graham, Kim, and Kim, 2026; Cziraki and Jenter, 2026). Most CEO positions are filled by insiders, and even well-performing CEOs are rarely hired away. Thus, most CEOs are unlikely to be in contention for

[14] Huang, Jain, and Kini (2019) show that instrumented-for industry tournament incentives are positively correlated with within-industry acquisitions for firms with excess cash.

another CEO job. While the pay-gap measure is correlated with acquisition announcement returns, the mechanism remains to be determined.

Promotion aspirations are more likely to be relevant for below-CEO executives, and many acquisition decisions are made by top management teams, rather than just by CEOs. Thus, the incentives of below-CEO executives are likely to matter, including incentives from wanting to become the next CEO. Lazear and Rosen (1981) and Rosen (1986) propose that competition for promotion to CEO induces executives to work harder, and they show that an effective promotion tournament requires that the top job pays substantially more than the positions just below.

The effect of a promotion tournament on the acquisition behavior of below-CEO executives is ambiguous. On the one hand, a promotion tournament should induce more effort. On the other hand, it might cause excessive risk taking, as executives try to differentiate themselves from their competitors (Hvide, 2002). Finally, it might cause executives to be excessively deferential to a CEO or board who want to make an acquisition.

Measuring the incentives from CEO promotion tournaments is difficult. Most of the literature, starting with Bognanno (2001), uses the compensation gap between the CEO and the firm's other top executives to proxy for tournament incentives. While likely correlated with promotion incentives, this measure also captures several other aspects of a firm's leadership, which complicates the interpretation. For example, a large compensation gap might indicate a highly talented CEO, or it might indicate an entrenched CEO who extracts excess pay (Bebchuk, Cremers, and Peyer, 2011).

Two studies have examined the link between the incentives from CEO promotion tournaments, measured by the pay gap between the CEO and other top executives, and acquisition decisions. Even though both papers use similar data sources over almost the same period, they report different results. Hasan, Navone, To, and Wu (2020) find that acquirers with stronger tournament incentives are more likely to do acquisitions but that these acquisitions create lower announcement returns. Nguyen, Phan, Phan, Tran, and Vo (2020) agree that stronger tournament incentives are linked to more acquisitions, but they

associate them with higher announcement returns, higher abnormal stock returns over the subsequent one to three years, and greater improvements in operating performance. It is unclear why the two paper's results diverge.[15]

Finally, returning to the incentives of CEOs, several papers show that acquisition experience—good or bad—is valued in the directorial labor market. Harford and Schonlau (2013) document that being CEO of a company that undertook a significant acquisition, even if that acquisition was value destroying for the firm, pays off in the directorial labor market. Thus, at least in terms of future board seats, there is no penalty for undertaking bad acquisitions. Field and Mkrtchyan (2017) provide some rationale for that finding by showing that a company's performance as an acquirer is improved when its directors have past acquisition experience (good or bad), even though it is improved even more if that past acquisition experience was value-increasing. Greene and Smith (2021) expand the investigation to all executives and show that past acquisition experience (again, good or bad) increases future compensation, board seats, and promotions to CEO. They conclude that the career benefits of acquisitiveness do not depend on deal quality.

### 2.3 Risk Reduction

Whereas shareholders hold diversified portfolios, CEOs have an undiversified exposure to their firm, in terms of both their human and financial capital. Thus, self-interested and rational managers can be expected to take actions to diversify the firm's operations, since they cannot diversify their exposure to the firm itself. Lewellen, Loderer and Rosenfeld (1989) presented evidence in favor of the managerial risk-reduction incentive for mergers. Aggarwal and Samwick (2003) model contracting between shareholders and managers who diversify their firms to capture private benefits and reduce non-systematic risk. Gormley and Matsa (2011, 2016) study diversifying acquisitions, showing that managers undertake them when the firms are facing liability risk, or simply to reduce other non-systematic risk. They further

[15] Even though both papers use the same data sources, their sample sizes are vastly different. This is in part because Nguyen et al. (2020) drop smaller deals, but they report that their results are robust to not doing so.

show that these acquisitions are not generally in shareholders' interest by relating the diversifying acquisitions to poor governance, worse stock price reactions, and managers' personal benefits from risk reduction.

## 2.4 Summary

In this section, we have highlighted that personal utility considerations beyond current compensation have substantial incentive effects on a CEO's decision to attempt an acquisition. CEOs might grow their firm through acquisitions to enjoy the prestige and status associated with running a larger firm. The desire to maintain private benefits of control can cause CEOs to defensively acquire so as not to become a target themselves. Career incentives in the director labor market, rather than providing settling-up for poor acquisition performance, appear to reward acquisition experience, even the experience of being a making a value-destroying acquisition. Finally, unable to diversify their large exposure to risk specific to their firm, rational CEOs can diversify the firm itself through acquisitions.

## 3 THE SECOND RING: INCENTIVES OF OTHER DEAL PARTICIPANTS

### 3.1 Target executives

This section examines the incentives of target executives. An acquisition transfers control of the target's business and usually ends at least the target CEO's tenure. This creates a conflict of interest between target shareholders, whose wealth increases because of the takeover premium, and target managers, who might lose income and private benefits of control, such as perquisites and status. Incentive compensation can alleviate or exacerbate this conflict.

Target managers who are reluctant to sell can be beneficial for shareholders because they can force the acquirer to pay a higher acquisition price (Harris, 1990). By calibrating both anti-takeover measures that allow target managers to resist and change-in-control payments that incentivize a sale, shareholders might be able to maximize their expected share of the synergies. However, if change-in-control payments are too generous, they might encourage managers to accept inadequate offers.[16]

The empirical literature has mostly focused on target CEOs, who are typically the most important decision maker on the target side (Graham, Harvey, and Puri, 2015). They influence whether a bid is solicited, resisted, or accepted, and they are often the main negotiators of a deal. Their incentives depend on the expected value of their current position and its perquisites, their holdings of company equity, change-in-control payments, and expectations of post-deal employment. Each of these components has been studied.

#### *3.1.1 Target executives' equity holdings, changes in wealth, and bid resistance*

When a firm receives a takeover proposal, target management needs to decide whether to accept, negotiate for a better offer, or outright reject. Much of this happens in private, without any information released to the public until after an offer is accepted (Boone and

[16] Gordon (2025) argues that this has been the case in many firms in the 21st century.

Mulherin, 2007), which makes research on resistance by targets difficult. Most studies of bid resistance therefore focus on tender offers, which are by definition public, and which were relatively common during the 1980s.

Bid resistance does not necessarily imply that target executives are not aligned with shareholders. Baron (1983) develops a model in which managers may resist a tender offer for one of three reasons: they reject the offer because they believe it is inadequate, they reject the offer anticipating a better one, or they resist the offer because they have a preference for control. Only the third reason is an agency problem. Consistent with the price-improvement motive for bid resistance, Bates and Becher (2017) show that resistance is more likely when the takeover premium on offer is low given the characteristics of the acquirer, target, and transaction.

Another complication with studies of bid resistance is that potential bidders are likely to pay attention to the incentives of target executives, including their equity exposure and compensation contracts, when deciding whether to launch a bid. If a bidder observes target executives whose incentives are not aligned with shareholders, they may decide not to bid, and the acquisitions that still go ahead are likely to be those with large synergies.

In this context, target executives' equity ownership has two distinct effects. A large fraction of shares held by target executives might imply powerful executives, especially if other shareholders are dispersed (Stulz, 1988). Large dollar ownership, on the other hand, implies greater exposure to the takeover premium and better alignment with other shareholders. Thus, ceteris paribus, we would expect high percentage and low dollar ownership to predict few takeover attempts, and to have an ambiguous effect on bid resistance and offer success for those bids that go ahead.[17] Low percentage and high dollar ownership, on the other hand, should be associated with more takeover attempts, and to again have an ambiguous effect on bid resistance and offer success.

[17] The ceteris paribus assumption could be violated for many reasons. For example, if managers who own large equity stakes manage their firms better, as suggested by Jensen and Meckling (1976), their firms would be less likely to attract disciplinary takeovers.

Focusing on officers' and directors' percentage ownership, Mikkelson and Partch (1989) find no relation with the likelihood of successful acquisitions. But they also show that this reflects two offsetting effects: firms in which insiders own a larger fraction of shares are less likely to become a target, but bids are more likely to succeed. In contrast, Ambrose and Megginson (1992) find that insider ownership has no effect on the likelihood of a takeover attempt. Song and Walkling (1993) find that takeover targets have lower insider ownership than other firms, and that insider ownership is lower in offers that encounter resistance than in uncontested offers. Hadlock, Houston, and Ryngaert (1999) show that banks with higher executive ownership are less likely to be acquired. Fidrmuc and Xia (2019) find that CEO ownership is positively correlated with target- rather than bidder-initiated acquisitions. While most of these patterns are consistent with executives' percentage ownership affecting whether a firm becomes a target, they are difficult to interpret without controlling for executives' dollar ownership.

Turning to dollar ownership, Walkling and Long (1984) analyze tender offers in the 1970s and find target resistance to be negatively related to the change in top executives' wealth due to the offer. The change in wealth is calculated as the effect of the takeover premium on the value of top executives' stock and option holdings, and the negative correlation with bid resistance obtains for both the change in wealth and for the change in wealth scaled by annual salary.

Cotter and Zenner (1994) use a sample of tender offers from the 1980s and expand the change in wealth measure to include change-in-control payments and the present value of lost compensation.[18] They confirm that bid resistance is negatively related to the change in top executives' wealth, and they show that the probability of offer success is positively related to it. When they disaggregate their measure of wealth change, both results are driven by executives' stock and option holdings, not by change-in-control payments or lost compensation.

[18] They assume that the target executive loses all executive compensation for the next 15 years or until age 65, whichever comes first, and discount the lost compensation at 3%. The evidence in Section 3.1.4 suggests that 15-year no-employment assumption is too pessimistic.

Cai and Vijh (2007) focus on the illiquidity discount associated with target CEOs' stock and option holdings. The discount is the difference between the equity holdings' fair market value and the certainty equivalent value assigned to them by a risk-averse and undiversified executive.[19] The assumption is that accelerated vesting causes the illiquidity discount to vanish when a firm is acquired. They show that firms of CEOs with higher illiquidity discounts are more likely to be acquired. In completed deals, CEOs with higher discounts accept lower premiums, are less likely to offer resistance, and are more likely to leave after the acquisition. Notably, Eckbo, Norli, and Thorburn (2026) find that, given a takeover bid, the likelihood that it was initiated by the target is increasing in the target CEO's vested equity but decreasing in their unvested equity. The latter is unexpected and seems inconsistent with Cai and Vijh's logic. However, most CEOs own much more vested than unvested equity, and they hold on to unvested equity because of ownership guidelines or to signal their confidence in the firm.

In sum, most of the evidence suggests that executives' dollar ownership increases their willingness to sell their firm. The effects of equity ownership on bid resistance or deal characteristics[20] are more difficult to interpret because equity ownership also affects the likelihood of receiving an offer, which creates sample selection bias. Ideally, studies should analyze offer likelihoods, bid resistance, and deal characteristics jointly and relate them to both executives' percentage and dollar ownership.

### *3.1.2 Golden parachutes*

The most studied component of target executives' incentives are contractual change-in-control payments, also called "golden parachutes." A golden parachute guarantees payouts to an executive in case their employment is terminated as a result of a corporate merger,

[19] Executives are assumed to have CRRA utility with a risk aversion coefficient of 2.5.
[20] For example, Moeller (2005) shows that the target CEO's percentage ownership is negatively correlated with takeover premiums.

takeover, or other change in control.[21] Typical golden parachutes include two to three times annual base salary plus bonus,[22] accelerated equity vesting, continued health benefits, and outplacement services. The prevalence of golden parachutes has increased over time: In 1982, 15% of public firms offered them (Knoeber, 1986), which increased to 50% in 1990 and to 78% in 2006 (Bebchuk, Cohen, and Wang, 2014), and further to 82% in 2014-16 (Choi, Lund, and Schonlau, 2020).

The main justification for golden parachutes is that they help align the interests of target shareholders, who want any value-increasing deal to go ahead, and target managers, who lose expected income and private benefits of control when selling the firm (Lambert and Larcker, 1985; Harris, 1990). In addition, Knoeber (1986) argues that golden parachutes protect managers' implicit deferred compensation against expropriation through a takeover, thereby decreasing shareholder opportunism and making ex-ante contracting between shareholders and managers more efficient. However, golden parachutes are not uncontroversial. They can insulate executives from the disciplining role of the takeover market, thereby reducing executives' pay-for-performance sensitivity (Lambert and Larcker, 1985; Bebchuk, Cohen, and Ferrell, 2009).

Lambert and Larcker (1985) examine announcement returns around the first-time adoption of golden parachutes and find a significantly positive average market reaction, consistent with the optimal contracting interpretation. Alternatively, firms might adopt golden parachutes when they have inside information that an acquisition is likely, and the market might respond positively to this signal.

Several studies link golden parachutes to an increased likelihood that a firm will receive a bid and is acquired (Machlin, Choe, and Miles, 1993; Sokolyk, 2011; Bebchuk, Cohen, and

[21] Most golden parachutes pay out if there is both a qualifying change in control and a qualifying termination of employment (double trigger). Other golden parachutes also pay out if there is only a change in control, even if the executive retains their position (single trigger). Single trigger parachutes have been criticized by investors and proxy advisors and tend to receive less voting support (Gillan and Nguyen, 2024).

[22] In the US, Section 280G of the Internal Revenue Code imposes a 20% excise tax on parachute payments that exceed three times the executive's average annual compensation over the five preceding years. Likely as a result, parachutes equal to three times average annual pay have become the norm.

Wang, 2014). This could be because golden parachutes make executives more amenable to selling their firm, or because golden parachutes are introduced when an acquisition attempt is likely. However, Machin et al. (1993) observe few acquisitions in the first year after a golden parachute is adopted, and Bebchuk et al. (2014) show that both recently adopted and older parachutes have the same positive association with acquisitions. This suggests that the positive correlation between golden parachutes and acquisitions is not driven by reverse causality.

The relation between golden parachutes and bid resistance has been examined by Buchholtz and Ribbens (1994), who find no relation, Machlin et al. (1993), who find a negative relation, Cotter and Zenner (1994), who again find no relation, and Subramaniam (2001), who finds a positive relation. Fich, Tran, and Walkling (2013) link larger golden parachutes to higher deal completion probabilities. Interpreting these results is difficult. First, boards might introduce golden parachutes if they expect their executives to resist bids, creating a positive relationship between parachutes and resistance even if the causal effect is negative. Second, since golden parachutes are associated with more acquisition offers, the marginal offers might be worse (e.g., have lower synergies), which could justify more resistance.

Several studies show that golden parachutes are negatively correlated with takeover premiums (Fich et al., 2013; Bebchuk et al., 2014; Qiu, Trapkov, and Yakoub, 2014). However, this does not imply that shareholders in firms with golden parachutes should expect lower gains. Fich et al. (2013) combine the lower average premium for firms with parachutes with their higher deal completion probability and find that the two effects cancel out. Bebchuk et al. (2014) combine the lower average premium for firms with parachutes with their higher acquisition likelihood and show that the net effect is positive: golden parachutes are associated with higher expected gains for target shareholders.

Finally, golden parachutes might be associated with lower value gains for acquirers and targets combined. This would be the case if the marginal deals caused by parachutes create lower synergies. However, this hypothesis is not supported by the data. Subramaniam (2001)

finds a significant positive association between golden parachutes and the combined return on the bidder-target portfolio around bid announcements, while Fich, Rice, and Tran (2016) find an insignificant positive association. Thus, there is no evidence that golden parachutes invite lower-value deals.

In sum, the evidence shows that golden parachutes are associated with higher acquisition likelihoods, less bid resistance, higher completion probabilities, and lower takeover premiums. This is consistent with golden parachutes making target executives more willing to sell their firm. However, the use of parachutes and their generosity are choices made by boards that might consider the likelihood of receiving a bid, the expected synergies, executive characteristics such as age and tenure, how generous executive pay is relative to the executive's outside options, the executive's equity exposure, and the executive's ability to influence the response to a bid.[23] Thus, there are many omitted variables that might bias regressions of deal characteristics on golden parachutes. Estimating the causal effects of golden parachutes would require assigning them (as good as) randomly to firms, which is infeasible.

### *3.1.3 Merger bonuses, golden parachute enhancements, and unscheduled equity grants*

Once a firm has received an acquisition proposal, its board has the opportunity to change its executives' compensation arrangements. Potential adjustments include augmenting golden parachutes, making unscheduled equity grants, and granting merger bonuses that pay off if and when the deal closes. Boards might make these changes to optimally adjust their executives' incentives, or captured boards might allow rent-extraction by executives who expect to lose their job in the acquisition. Shareholders might find it difficult to oppose

[23] For example, Knoeber (1986) reports that firms with low managerial ownership are more likely to have golden parachutes, consistent with boards using golden parachutes as a substitute for equity incentives.

rent extraction, since the pay adjustments are typically bundled with the merger proposal in a single take-it-or-leave it vote (Broughman, 2017).[24]

Hartzell, Ofek and Yermack (2004) show that 27% of target CEOs receive a merger bonus and 12% an increase in their golden parachute.[25] Hartzell et al. observe a negative correlation between these payments and the target CEO remaining an executive in the combined firm, suggesting that they compensate the CEO for losing their job. There is a positive association between these payments and prior "excess" compensation, consistent with both a settling-up payment or a captured board. Finally, there is some evidence of lower acquisition premiums when target CEOs receive merger bonuses, golden parachute enhancements, or positions in the combined firm, which Hartzell et al. interpret as indicative of a conflict of interest between target CEOs and shareholders.

Fich, Rice and Tran (2016) confirm that deals in which target CEOs receive merger bonuses are associated with lower premiums, but they show that there is no transfer of value to acquirer shareholders. Instead, deals with target-CEO bonuses have lower synergies and worse acquirer stock and accounting performance. Fich et al.'s interpretation is that merger bonuses are optimal contractual revisions: in low-synergy deals, a side payment might be required to get the target CEO to agree to the deal and would therefore be optimal for target shareholders.

Equity grants to target CEOs during deal negotiations have been analyzed in two studies, with seemingly contradictory results. Fich, Cai, and Tran (2011) show that more than 13% of targets award unscheduled option grants to their CEO during negotiations. Unscheduled grants are inversely related to the size of the CEO's golden parachute and positively related to the CEO's loss of future compensation. Acquisitions are more likely to be completed when the target CEO receives an unscheduled award. However, acquisitions premiums are

[24] In the US, the 2010 Dodd-Frank act mandates a non-binding shareholder vote on parachutes when shareholders vote on the sale of the firm.
[25] Many merger bonuses are framed as compensation for consulting or non-compete agreements.

significantly lower and acquirer returns higher if there is an unscheduled award, which Fich et al. interpret as evidence that these grants undermine the interests of target shareholders.

Heitzman (2011) finds that 33% of target CEOs receive equity grants during deal negotiations, and he shows that grants are more likely for CEOs who lead the deal negotiation. Heitzman includes both stock and option grants and makes no distinction between scheduled and unscheduled grants. Unlike Fich et al. (2011), he finds no relation between negotiation-period grants and acquisition premiums. The two results are, however, not directly comparable. Fich et al. focus on unscheduled option grants and include withdrawn bids in their sample, while Heitzman includes all stock and option grants but analyzes only completed deals. It is unclear which of these differences causes the different results, and how to interpret them.

In sum, there is considerable evidence that targets adjust their executives' pay incentives after they receive an acquisition proposal. To what extent these adjustments are in the interests of target shareholders is an open question. Since they are an endogenous response to the specific acquisition proposal received, identifying their causal effect on the same proposal's outcome is difficult. A more promising approach would be to analyze the empirical determinants of the incentive adjustments and to relate them to optimal contracting and rent extraction theories. For example, optimal contracting might predict greater incentive enhancements when merger synergies are low.

#### *3.1.4 Post-deal employment*

The core cause of the conflict of interest between target executives and target shareholders is that target executives are likely to lose their job when their firm is acquired, while shareholders benefit from an often-large takeover premium. However, the post-deal employment outcomes of target executives vary, and those outcomes can be a function of choices made during the acquisition process. Consequently, executives might be tempted to make choices that improve their employment prospects, even if those choices reduce shareholder value.

Several studies show high rates of post-deal job losses for target executives, especially for target CEOs. Walsh (1988) uses a survey to track the employment status of target executives in the five years after an acquisition. Turnover is significantly higher than for executives of control firms, and more senior executives are more likely to leave. It is unclear whether they are dismissed or quit on their own volition. As Hambrick and Cannella (1993) point out, executives might decide to leave after an acquisition because of their loss of relative status in the combined firm.

Martin and McConnell (1991) analyze successful tender offers and observe a turnover rate of 56% for the target's top executive between the bid announcement and one year after completion. Agrawal and Walkling (1994) include successful and unsuccessful bids and observe similar departure rates. They also show that most target CEOs do not obtain another executive position in a public firm within two years of a bid. Hadlock, Houston, and Ryngaert (1999) show that in 54% of bank acquisitions, the target's top executive leaves within two years. Hartzell, Ofek, and Yermack (2004) find that 66% (82%) of target CEOs leave by the time of the first (second) post-merger proxy statement. Only 35% are in an executive position at any firm two years after the deal. Thus, acquisitions are serious career setbacks for most target CEOs. However, Hartzell et al.'s sample ends in 1997, and we have been unable to find any more recent studies of the post-deal employment of target executives.[26] Given the many changes in the M&A market over the last 30 years, it would be interesting to know whether the outcomes for target executives have changed.

It is difficult to prove that target executives fear the negative effect of acquisitions on their careers. However, the evidence in Jenter and Lewellen (2015) suggests that executives care. Using retirement age as a proxy for CEOs whose cost from an acquisition is low, the study shows that acquisitions are significantly more likely when target CEOs are close to age 65. Premiums and target announcement returns are similar to those of younger CEOs, suggesting that retirement-age CEOs do not do worse deals. Proxies for better corporate

[26] Guo, Gupta, Moral, and Nanda (2024), whose sample spans 2000-2017, focus on acquisitions in which targets are fully absorbed by the acquirer, rather than kept as a subsidiary. They find that only 11.4% of target executives are retained by the acquirer, which is fewer than in studies that include all acquisitions.

governance predict more sales by younger CEOs and a smaller increase at retirement age, which suggests that an agency problem causes the increase around age 65. Jenter and Lewellen's interpretation is that younger CEOs are reluctant to sell their firms because of the expected career setback, and that they get away with rejecting at least some value-increasing deals.[27]

Even though most target CEOs do not become top executives in the combined firm, a significant subset does. Several studies have looked for evidence that target CEOs change their behavior in the deal negotiation in order to secure continued employment. Ghosh and Ruland (1998) show that target CEOs with large equity stakes are more likely to do stock-for-stock deals, which may give them influence in the combined firm and allow them to secure continued employment. Wulf (2004) shows that target shareholders receive a smaller share of the synergies in deals in which both firms obtain roughly equal post-merger board representation, which she interprets as target CEOs trading power for premium. Hartzell et al. (2004) find an insignificant negative correlation between the target CEO becoming an executive or director of the combined firm and takeover premiums. In contrast, Qiu, Trapkov, and Yakoub (2014) find a significant negative correlation between target CEOs being retained as executives and premiums. Thus, the evidence is consistent with some target CEOs giving up shareholder value in exchange for continued employment.

However, not all instances in which a target CEO is retained are evidence of an agency problem. Wulf and Singh (2011) show that target CEO retention is positively correlated with prior firm performance and CEO pay, which they interpret as markers of valuable human capital, and Bargeron, Schlingemann, Stulz, and Zutter (2017) show that target CEO retention is associated with higher takeover premiums in acquisitions by private equity firms. It is indeed likely that there are many instances in which the target CEO has firm-specific human capital that makes continued employment the efficient outcome.

[27] Eckbo, Norli, and Thorburn (2026) show that retirement-age CEOs are no more likely to initiate a sale. Instead, bidders are more likely to approach firms led by retirement-age CEOs, consistent with bidders paying attention to target CEOs' incentives.

### *3.1.5 Summary*

Target CEOs are typically their firm's main negotiator in an acquisition, yet a successful deal implies a loss of income and private benefits of control for most target CEOs. This conflict of interest is likely to be worse for CEOs who have not performed well and whose outside options are therefore worse, which is when a takeover might create the most value. The empirical evidence suggests that this conflict of interest can be mitigated through large equity holdings, which allow target executives to benefit from the takeover premium, through golden parachutes, and through adjustment to incentive pay once the negotiation has started.

Given that every merger proposal is different, it is impossible to perfectly calibrate the incentives from equity holdings and golden parachutes before a specific offer arrives. It can therefore make sense for boards to strengthen their executives' incentives after an offer has arrived, especially if the proposed deal creates relatively low (but still positive) synergies. However, this also opens the door to opportunistic rent extraction, especially since executives' time horizon has shrunk and because shareholders do not get a binding vote on the pay adjustments independently from their vote on the deal.

## 3.2 Acquirer and Target Directors

We turn now to the directors, who—nominally at least—control the decision-making process in any acquisition. As such, their incentives (and hence willingness to approve a transaction whether as a bidder or target) are important inputs to acquirer and target managers' considerations. Whereas the career considerations of managers had long been appreciated, and golden parachutes were a relatively early innovation to compensate target managers for compensation lost due to termination as part of a change in control, these same concerns for target directors were at first relatively underappreciated and studied.

Harford (2003), studying mergers in the 1990s, found that for most target directors, the loss of the annual retainer swamped any gains on their typically small equity holdings,

setting-up an incentive conflict similar to the one faced by target CEOs, but without the offset through parachute payments. He then asked whether the director labor market mitigated this conflict through settling-up with target directors who appear to self-interestedly block mergers. The study shows that directors of poorly performing targets who refuse a premium acquisition offer have fewer other board seats going forward. He concludes that this both provides some evidence that the director labor market is not completely captured by CEOs through the nomination process, and also that the market provides career incentives to align directors with shareholders.

One part of Harford's study simply documented the typical retention (or lack thereof) of target directors post-merger. In the typical case, the only target director retained post-merger was the target CEO, with all the independent directors losing their board seat. However, Ishii and Xuan (2014), studying the importance of social connections between target and acquirer boards, found that the fraction of target directors retained post-merger increases in the social ties between the two boards, thus altering the incentives to merge. It is worth noting that—while target directors still do not enjoy golden parachute payments—compensation practices for corporate directors have shifted toward a larger equity component since the period studied by Harford, so that gains on the directors' equity holdings now offset more of their lost seat-related compensation.

### 3.3 Shareholders

Of course, boards are meant to represent shareholders' interests, and if they fail to do so, the shareholders themselves have incentives to block value-destroying mergers. However, a series of studies have documented exceptions to that assumption. Bae, Kang, and Kim (2002) examine controlling shareholders, the case where privately captured benefits are most likely to drive a wedge between outside, minority shareholders' interests and those of management and the shareholders with the power to intervene. Analyzing South Korean business groups ("chaebol"), they find that controlling shareholders can direct one member

of a chaebol to make an acquisition that decreases its own value, but increases the value of other members of the chaebol, leaving the controlling shareholder net better off.

Outside of business groups, other authors have studied similar offsetting impacts coming from a shareholders' other portfolio firms. Matvos and Ostrovsky (2008) argue that most large institutional investors hold shares in both the acquirer and target in a typical proposed merger. Such cross-holdings, they conclude, give those institutions an incentive to support a merger where the acquirer overpays for the target, because of the gain on their target shares. Although such misaligned incentives are plausible, Harford, Jenter, and Li (2011) show that in reality, they are rare. Specifically, the cases where a given bidder shareholder is a net seller due to its position in the target are also the cases where those bidder shareholders have relatively small holdings in the bidder, leaving them with no influence over the bidder managers. Institutions with large, influential holdings in the bidder are, almost by construction, typically net buyers relative to their holdings in a target, resulting in alignment with other bidder shareholders in having incentives not to overpay.

Two papers study different aspects of acquirer shareholders' portfolios: bonds, and non-merging rival firms. Bodnaruk and Rossi (2016) study so-called "dual-holders," which are institutions that own equity and debt of the target, noting that in the aggregate, a significant portion of a target's equity is typically held by dual-holders. Notably, many mergers increase the value of the target's bonds because the debt is assumed by the normally larger and more stable acquirer or, by the argument of Lewellen (1971), the debt of the combined firm is safer simply because the volatility of the combined firm's cash flows is lower due to the combination of two non-perfectly correlated businesses. With such an incentive coming from their debt holdings, dual-holders could favor lower premium offers as long as the target's bonds increase sufficiently in value, an outcome that Bodnaruk and Rossi find evidence for.

Moving beyond the financial claims of the direct parties to the merger, Anton, Azar, Gine, and Lin (2022) note that scholars have long-studied acquisitions' impact on rivals. Rivals can benefit when an ill-conceived acquisition leaves a competitor worse off, or they can even

benefit in a well-motivated acquisition that increases pricing power in the industry. Regardless of the reason, the fact that the acquisition impacts non-merging parties again raises the issue of whether an institution's broader portfolio will misalign its incentives with those of other acquirer shareholders. For example, even if the acquirer is overpaying for an acquisition that increases everyone's pricing power, an investor may favor it due to the positive impact on its holdings of the acquirer's rivals. Anton et al. find that mutual funds with more rival ownership are more likely to vote in favor of an acquisition, consistent with their supposition.

The general point to take from the papers on shareholder incentives is that the classic assumption that all shareholders agree on whether to make an investment or not breaks down in the case of acquisitions. The reason is that acquisitions create externalities on other claims and other parties, and all shareholders do not hold identical portfolios, so that the impact of those externalities differs across shareholders. Thus, the incentives of bidder shareholders in an acquisition vary in ways that can cause some of them to support an acquisition that will decrease the value of the bidder's equity. However, it is a separate question whether shareholders experiencing a net benefit from such an acquisition hold enough of the bidder's equity to be influential.

On the target side, a special set of shareholders is that of merger or "risk" arbitrageurs—those shareholders who enter either in anticipation of, or after the announcement of, a merger and attempt to profit off of the successful completion of the deal. The standard position of an arbitrageur is to short the acquirer and buy the target, so that they partially neutralize their market exposure and profit if the deal closes (so that the target's price converges from below to the offered price). Their incentives are different from those of long-term shareholders (some of whom they replace) in that they simply want the deal to close.

Cornelli and Li (2002) show that in equilibrium, the incentives of risk arbitrageurs to accumulate significant stakes in a takeover target will impact many aspects of a bidder's strategy, including the toehold and premium. In fact, turnover in target institutional shareholders post-merger announcement (documented by Baker, Coval, and Stein, 2007)

changes the incentives of both the bidder and target managers; bidder managers know that they do not have to convince the target's long-term shareholders of the value of the deal because they have largely sold-out to the risk arbitrageurs, and target managers' incentives incorporate the fact that a large portion of their shareholder base now simply wants them to negotiate to close the deal. This turnover in the shareholder base of both the target and bidder documented in Coval, et al. was largely overlooked in the literature, and its implications for assumptions of shareholder value-maximization preferences in a merger remain understudied.

### 3.4 Investment Bankers

One should not overlook the influence and incentives of investment bankers, important financial intermediaries who facilitate and advise on mergers, but who have their own incentives to increase deal flow, from which they derive their fees. This agency conflict has long been recognized, but the typical advisory contract, making the largest portion of the banker's fee contingent on the deal closing, remains unchanged. McLaughlin (1990, 1992) discusses investment banking contracts and their contingent nature, noting the conflict of interest over the price paid by bidding firms (the fee is often proportional to the value of the deal, and the deal is more likely to close when a higher price is offered). Rau (2000) documents that the post-acquisition performance of the acquirer is negatively related to the contingent fee payments charged by the investment bank. He concludes that the contingent fee structure gives bankers an incentive to focus on completing the deal over deal quality.

Two papers broaden the incentive lens on investment banks beyond those directly advising in the deal. Deal advisor incentives spill over to affiliated financial analysts, who issue recommendations around deals that are consistent with the advisor's incentives (Kolasinski and Kothari, 2008). Bodnaruk, Massa, and Simonov (2009) show that financial conglomerates whose affiliated investment banks advise bidders, take positions in M&A targets before announcements. This further increases the advisor's incentive to encourage deal completion regardless of value of the bidder. Thus, given their central role in both

pitching potential deals to acquirers and advising conditional on a bid being made, their misaligned incentives have the potential to distort which deals get proposed, at what price, and whether they close.

## 3.5 Summary

In this section, we have endeavored to provide an overview of the incentives of parties other than the acquiring CEO in a merger. There are many such parties: the target CEO, directors on both sides of the transactions, shareholders, and advisors. Importantly, not only do their incentives directly impact the design and outcome of a given transaction, but, in equilibrium, must also enter into the acquiring CEO's analysis of whether to pursue the transaction in the first place. As we will argue throughout this chapter, whereas the individual components of the web of incentives impacting mergers have each been well-studied, we understand less about the interactions among them, which is critical for moving the literature forward.

## 4 THE THIRD RING: GOVERNANCE MECHANISMS THAT CHANGE INCENTIVES

Having discussed the incentives of the CEOs and other deal participants, we turn to the governance mechanisms impacting those incentives, beginning with the board itself, which notably is tasked with mitigating the CEO's agency conflict while itself being an agent of the shareholders with its own preferences during takeovers that, as discussed in the previous section, can deviate from those of shareholders. We then discuss the influence of shareholders, in particular block and institutional holders, and finally other participants such as creditors and analysts.

### 4.1 Acquirer Boards

We reviewed the incentives of directors in the previous section, and here we turn to their role in reigning in the incentives of acquisitive CEOs. Listing requirements now mandate majority independence, and—at least with respect to acquisitions—the literature provides consistent evidence in favor of the positive role of independent directors (see a meta review of the literature by Hussaini (2025)). Early empirical work by Byrd and Hickman (1992) establishes that an independent director majority is associated with better announcement returns for acquirers.

But what about when the stock price reaction to an announced merger is negative? The stock market reaction is informative, providing feedback to decision makers at the acquirer about the advisability of the merger, but how they act on it is a function of their own incentives and information. Paul (2007) shows that more independent boards are less likely to complete bids that are met with a negative stock price reaction. Further, they are more active in asset restructuring if such an acquisition is completed. These facts establish an ex-ante check on CEOs with independent boards against proposing empire-building value decreasing transactions.

What about boards that do not act in shareholders' interests? Gholami and Elnahas (2024) study highly co-opted boards around mergers and acquisitions. They define co-opted

boards based on the fraction of directors who joined the board after the CEO (Hermalin and Weisbach, 1998). They find that firms with co-opted boards make worse acquisitions. Notably, they document an interaction between the reduced monitoring by the co-opted board and weak external monitoring (low institutional ownership), and the risk-taking incentives created by the CEO's compensation contract.

Since Roll (1986) made the argument that overconfidence and self-interest are virtually impossible to empirically distinguish, scholars have struggled to establish whether value-destroying acquisitions are the result of incompletely controlled managerial personal incentives, or are proposed by managers who are sure they are maximizing shareholder value, but are simply wrong due to their own hubris. Kolasinski and Li (2013) attempt to identify overconfident CEOs and then show that stronger, independent boards help those overconfident CEOs avoid acquisition mistakes; that is, overconfident CEOs are known to be acquisitive, but in the presence of stronger, independent boards, those acquisitions are less likely to be value-destroying.

Whereas Paul's and Kolasinski and Li's evidence points to the monitoring role of an independent board, Wang, Xie and Zhu (2015) point to the board's advising role in an acquisition. Specifically, they show that when making a diversifying acquisition, the presence on the acquirer board of independent directors with experience in the target's industry increases the acquirer announcement return. This suggests that some value-reducing diversifying acquisitions might not be caused by misaligned incentives but by missing expertise on the acquirer board.

Finally, Chen, Lei, and Xia's (2025) analysis points to an interaction between incentives and expertise on acquirer boards. Specifically, they argue that CFO board membership can create shareholder value when CFOs' interests are closely aligned with shareholders through equity ownership. Acquisitions made by firms with CFOs on their boards have significantly better acquirer announcement returns, partly because CFO directors select targets with better strategic and financial fit.

### 4.2 External Monitors: Creditors

Clearly, the incentives of managers in acquisitions are strongly affected by internal mechanisms such as their compensation, the need to gain board approval of the acquisition, and a desire to not be terminated for proposing value-decreasing acquisitions. Those internal incentive mechanisms exist in equilibrium with external monitors that both complement and substitute for the internal mechanisms.

One prominent set of external monitors are creditors, who exercise contingent control through covenants and bargaining power in renegotiations after a violation. Nini, Smith, and Sufi (2012) show that creditors take strong action to reduce investment and protect their claims following a violation of a financial covenant. Such violations result in immediate declines in acquisitions and capital expenditures, as well as reductions in leverage and shareholder payouts. While the prospect of losing full authority over firm policies provides indirect incentives to CEOs, the most direct impact on CEO incentives comes from increases in turnover following covenant violations.

In a later paper, Becher, Griffin, and Nini (2022) conclude that creditors play a direct role in constraining value-decreasing acquisitions stemming from agency conflicts. Almost 75% of loan agreements include restrictions that limit acquisitions. After a covenant violation, creditors use control rights and renegotiation to tighten these restrictions, which is followed by a significant decline in value-decreasing (but not value-increasing) deals. The takeaway from these two papers is that creditors are an active part of the system disciplining managers, and in particular reducing value-decreasing acquisitions, but their rights are mostly contingent—acting through increased power after covenant violations.

### 4.3 External Monitors: Analysts

Analysts play both an information intermediary role as well as a monitoring role, by calling-out or questioning managers about questionable decisions. As such, they serve as an external check on both managers and lax boards. Chen, Harford, and Lin (2015) provide

evidence using brokerage mergers to exogenously shock the number of analysts covering a firm. When there is an exogenous decrease in analyst coverage, a range of manifestations of agency conflicts increase, including value-decreasing acquisitions. This evidence establishes that analysts are an important and continuous (as opposed to contingent) component of the external monitoring system restraining managers' incentives to empire-build.

### 4.4 External Monitors: Shareholders

Large shareholder monitoring can complement and substitute for board monitoring of managers' incentives in M&A. Billett, Garfinkel, and Jiang (2011) estimate a hazard model showing that strong shareholder governance deters managers from pursuing large investments, consistent with shareholders curtailing overinvestment. Schmidt and Fahlenbrach (2017) use Russell reconstitutions to show that firms carry out worse acquisitions after exogenous increases in passive ownership.

Duchin and Schmidt (2013) provide indirect evidence on the importance of outside monitoring by showing that acquisitions initiated during periods of high merger activity ("merger waves") are accompanied by poorer quality of analysts' forecasts, greater uncertainty, and weaker CEO turnover-performance sensitivity. Duchin and Schmidt's argue that increased takeover activity both allows bad mergers to pool with good ones, and increases the cognitive load on external monitors, reducing their efficacy. Similarly, Kempf, Manconi, and Spalt (2017) find that firms with distracted[28] shareholders are more likely to announce diversifying, value-destroying acquisitions.

Related to the idea of limited attention, Fich, Harford, and Tran (2015) point out that the relevant metric of monitoring intensity should measure the total ownership of institutions for whom a given company is an important part of their portfolio. When an institution's holding

[28] They primarily use a major event in an unrelated industry represented in the institutional investor's portfolio to identify times when an institutional investor is distracted.

in a particular firm is in the top 10% of its holdings, it has incentives to expend resources monitoring that firm and its management. They support their argument by showing that targets with a greater proportion of such "monitoring institutions" bargain for higher premiums (resulting in lower acquirer returns), and are more likely to complete a proposed deal.

Interestingly, Goldman and Wang (2021) show theoretically that it need not be the case that influential investors have incentives to curb bad acquisitions. Specifically, they show that a large investor with the ability to produce superior private information and trade on it has a complex set of incentives. First, it could favor acquisitiveness in general because the increase in uncertainty around the bidder's stock price increases its potential trading profits. Second, the ability to generate private information about the value of a proposed acquisition and trade on it could lead it to not oppose a bad acquisition, because its potential trading profits exceed the value it could gain from intervening to stop the value-destroying merger.

The totality of the evidence suggests that shareholders, whether activist or not, substantially impact the incentives of managers of both potential targets and acquirers. Monitoring by institutional investors—most of whom are not explicitly activist—curbs the empire-building motives of would-be acquiring managers. Much of the evidence points to value-destroying effects when such monitoring is impeded, whether because of a spike in merger activity, or other events that distract institutional investors, or through the substitution of passive for active ownership. Activists are most important on the potential target side, as they are typically attracted to poorly performing companies, and agitate for outright sale, or strategic change (Brav, Jiang, Partnoy and Thomas, 2008; Boyson, Gantchev and Shivdasani, 2017). However, their interventions are also associated with fewer outbound acquisitions by the targeted management team (Bethel, Liebeskind, and Opler, 1998).

Of course, one might expect the final check on empire building to be shareholder voting; managers, knowing that they must secure shareholder support, should have incentives to only propose value-increasing mergers in the first place. However, U.S. law allows acquirers to structure an acquisition so that acquiring shareholders are not afforded a direct vote on

the acquisition. On the other hand, listing requirements of the major exchanges demand that shareholders approve any new equity issuance where the amount of issued equity will exceed 20% of the existing base. This sharp threshold separating acquisitions that require acquirer shareholder approval from those that do not provides a useful experimental setting with which to examine manager actions.

Becht, Polo, and Rossi (2016) and Li, Liu, and Wu (2018) both study mergers in the context of this threshold. Becht, Polo, and Rossi (2016) find that being forced to seek shareholder approval is a binding constraint for managers; acquisitions requiring a shareholder vote are less likely to be value-destroying. Li, Liu, and Wu (2018) study managerial manipulation of deal terms around the threshold, finding that acquirers with greater potential agency problems are more likely to structure the method of payment in the deal to stay below the 20% threshold and bypass shareholder voting. The consistent takeaway from these studies is that acquirer shareholder approval is not automatic, and that acquiring management actively structures deals to avoid this check on potential value-destructive transactions.

### 4.5 Summary

After reading both this and the previous section, one can begin to appreciate the complexity of the system of incentives surrounding a merger transaction. Many of the very parties that have their own, often divergent incentives, are also tasked with restraining, and thereby changing, the incentives of acquirer managers to merge and of target managers to resist. The evidence we cite in this section largely suggests that, on average, these parties perform their monitoring and disciplining roles correctly. This in turn is evidence that the incentive problems identified in the previous section, while real, are not dominant in the typical transaction. Nonetheless, as we continue to emphasize in this chapter, the interplay of parties who are simultaneously agents and monitors of other agents, is understudied relative to the study of those two roles independently.

## 5 THE FOURTH RING: THE TAKEOVER MARKET AS AN INCENTIVE MECHANISM

Managers' and directors' incentives shape acquisition activity, and acquisition activity shapes their incentives. Jensen and Ruback (1983) famously characterized the M&A market as a market for corporate control where management teams compete for control of assets, with shareholders as the referees. This fact—that poorly performing managers could lose their position managing assets to another management team—impacts incentives of managers (and directors) of both potential targets and acquirers.

In particular, both the optimal and observed pay-performance sensitivity, as well as turnover-performance sensitivity, set by boards is different in active versus inactive takeover markets. Starting in the 1990s, papers noted this association: Schranz (1993) takes advantage of the heterogeneity in takeover regulation across U.S. states and documents that firms in U.S. states with an active takeover market are more profitable. Notably, restricted takeover activity is associated with increased use of other mechanisms that provide an incentive to maximize firm value, such as concentration of equity ownership and management ownership of stock, which suggests that an active takeover market and other governance mechanisms are substitutes.

This idea is supported by Kini, Kracaw, and Mina (2004), who find elevated turnover of poorly performing target CEOs after takeovers during the active takeover period of the 1980s, but only for firms in which non-takeover monitoring mechanisms (like blockholdings and independent boards) are absent. On the acquirer side, Burkart and Raff (2015) make the point that successful managers are the ones afforded takeover opportunities, and as such, in an active takeover market, firms could reduce performance-based compensation due to the link between good performance and being an acquirer.

On the other hand, Mikkelson and Partch (1997), studying a time series of U.S. data, document that poorly performing managers were significantly less likely to turn over during periods of slower takeover activity. They conclude that an active takeover market strengthens board monitoring by creating a credible external threat to board inaction. Thus,

an active takeover market and internal governance discipline might be complements, rather than substitutes.

Lel and Miller (2015) exploit the staggered implementation of takeover laws across countries to establish a causal link from takeover activity to more disciplinary action by boards. They first confirm that when takeovers are easier, poorly performing firms experience more frequent takeovers and directors of targeted firms are more likely to lose board seats following a bid. Crucially, they go on to show that the sensitivity of CEO turnover to poor performance increases when takeovers are easier, again suggesting that internal governance is enhanced by an active takeover market.

Taking the results of these papers together, the interaction of the takeover market and internal incentives starts to come into focus. A board perfectly aligned with shareholders can consider the incentives provided by the takeover market in setting the performance sensitivity of CEO pay; an active takeover market provides a credible threat of dismissal through takeover for poor performance, a classic form of ex-post settling up as discussed in Fama (1980). This implies that external discipline through the takeover market and internal discipline by the board are substitutes, consistent with the evidence in Schranz (1993) and Kini et al. (2004).

However, a large literature points to substantial evidence of varying degrees of board capture in the population of public firms. Board members also face dismissal—loss of a board seat and potentially future board seats—from a takeover following poor performance (see Harford (2003)). Thus, an active takeover market also incentivizes boards to be more vigilant in their own monitoring responsibilities, which makes the takeover market and board discipline complements, consistent with the evidence in Mikkelson and Partch (1997) and Lel and Miller (2015).

Of course, target boards and managers have many tools to thwart unwanted takeovers. So, using structural estimation methods, Wang and Wu (2020) attempt to estimate the welfare loss created by managers rejecting good mergers or even initiating bad ones to keep their own jobs and prestige (as in Gorton, Kahl, and Rosen (2009)). While this loss is

substantial, with 12% of good deals being blocked and 17% of bad mergers going through, they also find that the fear of being targeted and consequently losing their jobs causes managers to work harder, and through this effect, the value created by an active takeover market increases by 21%. Overall, a reasonable inference from the literature is that an active takeover market provides net welfare-increasing incentives to managers that interact importantly with their compensation incentives.

Our discussion so far has focused on takeovers, but even absent a full takeover, the threat of activist shareholders accumulating blocks of shares and demanding change or a sale of the firm has strong incentive effects as well. Bethel, Liebeskind, and Opler (1998) find that activist block purchases are followed by more asset divestitures, fewer outbound mergers and acquisitions, and better stock and operating performance. Boyson, Gantchev, and Shivdasani (2017) find that even failed bids for activism targets lead to improvements in operating performance, financial policy, and positive long-term abnormal returns. Both papers conclude that transactions falling into the broad category of acquisitions of partial control are an important part of the overall system limiting agency costs in corporations. Celentano and Levine (2025) formalize this result in a model that combines both activism and outright M&A. Their model shows that both the threat of activism and actual activist intervention create shareholder value by improving target CEO incentives, while the value from reduced takeover frictions is primarily captured by acquirers.

A key takeaway from this section is that the incentives of managers to acquire paradoxically limits their ability to do so. Specifically, in a form of mutual monitoring, CEOs must keep in mind that if they perform poorly (including by making value-destructive acquisitions), other CEOs could bid for their firm. Boards are aware of this as well, dispatching their own monitoring duties more aggressively when the threat of takeovers is greater. In this way, the aggregate acquisition activity—itself an outcome of the incentives to acquire—strengthens other incentive mechanisms by standing as a credible threat of substitute discipline should those mechanisms fail.

## 6 CONCLUSION

As we said at the outset, a proper review of all the parties to a merger and their incentives is a big task. We drew a boundary at incentives that impact the focus on value maximization, which still left a large literature to review

Our review of the literature yields several broad themes. First, executive compensation structures can push toward deal-making, intentionally or not. More than a third of US public firms tie payouts to revenue growth, and almost none exclude acquired growth. EPS-linked pay also shapes deal structure, such as favoring cash to avoid dilution. Equity incentives matter in different ways depending on whether one looks at dollar or percentage ownership, and the evidence linking them to deal quality is mixed. Crucially, acquirer CEOs are often not worse off from making value-decreasing acquisitions. Pay increases, new equity grants, and M&A bonuses frequently offset losses on CEOs' stock and options. This strengthens their incentive to acquire and weakens their incentive to avoid bad deals. For acquirer CEOs, non-pay motives are also important. These include empire building, status (such as chasing the Fortune 500 cutoff), defensive "eat-or-be-eaten" deals, and diversifying the firm because CEOs can't diversify themselves. Career incentives only partly settle up: CEOs face higher turnover after bad deals, but acquisition experience, good or bad, is rewarded in the director labor market.

On the target side, executives face a built-in conflict, and boards manage it with several tools. A sale usually ends the target CEO's job, but shareholders benefit from the premium received, so boards use large equity holdings, golden parachutes, and incentive adjustments for CEOs after an offer arrives. Evidence suggests that these make executives more willing to sell, though resistance can also be a legitimate attempt to extract a higher price. Parachutes are linked to more bids, higher completion, and lower premiums, but they don't appear to produce lower-value deals. A non-trivial fraction of target CEOs are paid merger bonuses and/or get equity grants during negotiations. These could be optimal side payments in low-synergy deals or rent extraction by captured boards, and the evidence cannot cleanly separate the two.

Other deal participants have divergent incentives. Target directors lose retainers and seats, shareholders with cross-holdings or holdings in rival firms may favor bad deals, and merger arbitrageurs simply want the deal to close. Bankers' contingent fees reward completion over quality. Because these incentives are anticipated by potential acquirers, they affect which deals get proposed at all, not just how they play out.

Governance works, but with gaps. Independent boards, analysts, creditors, and institutional investors all help curb value-destroying deals. Co-opted boards, passive or distracted shareholders, and merger waves weaken that discipline. When possible, managers structure deals to stay under the 20% issuance threshold, thus avoiding the discipline of a shareholder vote. Paradoxically, the takeover market itself disciplines managers, and acquisitiveness is part of the mechanism. The threat of being acquired pushes managers to behave and boards to monitor more closely. And so, while misaligned incentives are real, the majority of deals do create value.

Going forward, we must accept that the literature necessarily struggles with causality and selection. Pay, ownership, and parachutes are chosen by boards in anticipation of deals and vary with unobserved firm characteristics, so correlations are often hard to interpret. On the target side, bidders screen on executive incentives before bidding, which muddies the inferences from studies of resistance. Nevertheless, the literature has significantly built our understanding of each of the myriad incentive forces impacting the merger and acquisition market. The largest gaps in the literature are studies of how those forces interact with each other in the complex web of offsetting and reinforcing incentives among the different decision makers, each of whom recognizes the others' incentives. Although challenging, this strikes us as the most fruitful avenue for future research.

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