

CEO Options and Illusory Incentives

Do Insiders get more equity before a Merger?

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CEO “Options”

CEOs have considerable discretion about the timing and mix of their own compensation

- 1 Evidence that CEO options are backdated (Lie, 2005 and Heron and Lie, 2007)
- 2 Evidence that CEO options exercises are optimally timed to minimize taxes (Cicero, 2007).
- 3 M&A announcements are times of great temptation
 - SEC litigation data suggests that insider trading (by corporate officers) is highest around Mergers and Acquisition announcements (Agudelo, Bhattacharya and Henkel, 2007).
- 4 What about CEOs being granted more options when the probability of a takeover is likelier?
- 5 What about CEOs preferring options when they know, as an insider, that a takeover is highly likely, and possibly imminent?
- 6 We can also look at the [Directors](#) as well as the CEO.



Research Questions

This paper wants to answer two questions

- 1 Are CEOs granted more equity prior to a takeover?
- 2 Is it related to agency, insider trading or other motives?
 - For instance, an agency story might be that perhaps increased equity is necessary to induce the CEO to give up control.
 - Alternatively, increased equity could be considered optimal incentive alignment to encourage CEOs to hold out for the highest price



Five Tests

- Test 1 CEOs of target firms experience and increase in equity grants the year of or before a takeover.
- Test 2 CEOs of target firms show a greater increase in equity grants before a takeover than the CEOs of year-size-industry matched firms.
- Test 3 The percent increase in year-to-year equity compensation is a useful variable in predicting takeovers.
 - This would be a **novel** predictor in the TKO literature
- Test 4 Economic Significance: an estimation of the financial gains resulting from the incremental increase in equity compensation before a TKO.
- Test 5 Agency vs. Optimality: Do firms with increased equity compensation receive higher or lower TKO prices than matched firms?



NEEDS

- Test 1 Requires equity compensation data for 2 years and 3589 firms, $2 \times 3589 = 7178$ observations.
- Test 2 Requires the same data for a sample of matched firms, so another 7178 observations.
- Test 3 Can use just the matched data, but would be better with using the full Compustat universe, of which Execucomp covers the S&P1500.
- Test 4 Piece of cake using the other data and SDC.
- Test 5 Test design TBA.



DATA

- 1 I have 3589 consummated M&As from 1992 – 2005, hand-matched between SDC and CRSP/Compustat.
- 2 The intersection of the SDC mergers, CRSP, and Compustat-Execucomp is about 550 firms.
- 3 I am in process of hand-collecting another sample of 300 firms, for comparison with Execucomp.
- 4 I have a C# program that can pull some of the relevant Execucomp data, if given a URL. Still working on ways to get more compensation data.
- 5 Will pilot the study on my subset of 550 firms.

