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Boards of Directors' Self Interest: Expanding for Pay in Corporate Acquisitions?

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ABSTRACT. Director compensation can potentially represent an ethical minefield. When faced with supporting strategic decisions that can lead to an increase in director pay, directors may consider their own interests and not solely those of the shareholders to whom they are legally bound to represent. In such cases, directors essentially become agents, rather than those installed to protect principals (shareholders) from agents. Using acquisitions as a study context, we employ a matched-pair design and find a statistically significant difference in outside director compensation between acquiring and control firms. Outside directors of acquiring firms earn more than twice as much as their counterparts in the matched-sample.

KEY WORDS: acquisitions, agency theory, board of directors, director compensation

In a recent article titled "The Top 10 Legal Milestones of the Last 10 Years," the Sarbanes–Oxley Act (SOX) of 2002[1] was cited as *the* top "legal milestone of the last ten years" (Myers, 2005, p. 1). Among other developments noted in this "Top Ten" list were several that also directly addressed boards of directors. These include (a) the Disney decision of the Delaware Chancery Court that greatly expanded the duty of good faith; (b) the personal liability of directors; (c) the Caremark

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decision that expands the responsibility of directors to maintain effective compliance programs; (d) the large increase in mass tort product-liability litigation in which directors themselves may be liable; (e) the increased influence of shareholder proposals in which directors are often targeted; and, (f) the activism of institutional shareholders as plaintiffs in class action lawsuits in which directors are often defendants.

That this focus on the roles and responsibilities of boards of directors dominates these legal ''milestones'' is not surprising. Consider, for example, the extensive sections in SOX (see endnote 1) that dictate the nature of relationships between auditors and the board of directors, specifically boards' audit committees. Notably, similar guidelines are not prescribed for relationships between senior executives and outside constituencies. The listing requirements of the major stock exchanges (New York Stock Exchange [NYSE],[2] American Stock Exchange [AMEX],[3] and NASDAQ[4]) provide another example of the clear focus on guidelines for directors, with particular emphasis on matters of required board committees (audit,[5] compensation, nominating, corporate governance) and the composition of those committees (a minimum of three directors, all of whom must be independent).

A common theme evident across this array of guidelines (e.g., SOX, exchange listing requirements) is the independence of directors and the notion that this independence will result in dispassionate decision-making, not compromised by self-interest. While current guidelines articulate this matter of independence, the foundations for director independence presage those principles by many years. Consider, for example, what may be a definitive statement on director self interest proffered nearly 70 years ago:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests … A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of this duty, not only affirmatively to protect the interests of the corporation committed to his charge … **The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest** (Chief Justice Layton in Guth v. Loft, Inc. [5 A.2d 503, 510, Del. 1939]; emphasis added).

Some commentators, however, have questioned the veracity of the independence assumption, whether in directors' monitoring role or in an application of that role through their ratification of executive decision making. In a recent interview, for example, Warren Buffett suggested that as many as 20 percent of *Fortune* 500 board members generate approximately one-third of their total income from board compensation packages. Given this, Mr. Buffett questioned how directors ''can truly exercise independent judgment'' (Bary, 2003, p. 21).

Implicit in much research on boards of directors is the notion of balance (Dalton and Daily, 2001). In other words, firm executives and board members should strive to ensure that the interests of stakeholders are protected or at least considered. However, the ethical foundation for such decision making is less well understood, particularly when those involved in the decision stand to gain personally. Nonetheless, the conflicts of interests postulated by agency theorists have generated interest among ethics scholars (e.g., Bohren, 1998; Shankman, 1999; Velamuri and Venkataraman, 2005). We draw on extant research investigating the relationship between CEO compensation and merger and acquisition (M&A) activity to advance our understanding of the potential conflicts of interests directors face in ratifying a central strategic decision – that is to engage in M&A activity or not. That is, does directors' compensation present an ethical minefield?

In the following sections, we examine the extent to which directors may benefit as a result of their decision making responsibilities. In particular, we examine director compensation packages following M&As. We rely on agency theory (Jensen and Meckling, 1976) to highlight the potential conflicts of interest faced by directors. Despite the fact that most acquisitions deliver negative returns to the shareholders of acquirers (for a review of this literature, see King et al., 2004), we find that director compensation packages increase following M&As. These findings suggest that directors do, in fact, face an ethical dilemma: they may at times personally benefit from ratifying decisions that have the potential to reduce shareholder value.

Theoretical framework

Agency theory addresses the divergence of interests that may result when executives are motivated to act in self-interest as opposed to acting in accordance with shareholders' interests (Fama and Jensen, 1983; Jensen and Meckling, 1976). Although it is possible that executives make decisions that jointly satisfy their own interests as well as those of shareholders, it is also possible that executives may make decisions that satisfy their own interests at the expense of the shareholders. To alleviate these potential conflicts of interests between owners and executives, a number of monitoring mechanisms are prescribed (e.g., CEO compensation, boards of directors, investor activism).

Agency theory has recently received a great deal of attention from ethics scholars. Perhaps this recent attention is due in part to Bohren's (1998) observation that the principal-agent model is a specialized case of the more generalized theories of human nature that date back to the Sophists in ancient Greece. More recently, agency theory has been employed by ethics scholars to examine moral choice (Woodbine and Taylor, 2006), employee misconduct (Kidder, 2005), CEO compensation (Matsumura and Shin, 2005), and the events surrounding the failure of Enron (Kulik, 2005).

We extend this research by relying on agency theory principles as a means for enhancing our understanding of the compensation received by boards of directors. The board of directors operates as a representative of shareholders by monitoring executives' decisions. Absent from extant literature is a treatment of the interests of directors and the potential for self-interest to impact their monitoring or ratification of executives' decisions. In the following sections, we highlight a potential ethical dilemma that directors face. Put differently directors, intentionally or otherwise, may have their own set of self-interested motives.

Directors and self-interest

The role of directors in the critical outcomes of firms continues to generate interest across a variety of disciplines including business ethics, strategic management, finance, accounting, and law (e.g., Belden et al., 2005; Cain, 2003; Daily and Dalton, 2003; Deutsch, 2005; Farber, 2005; Hillman, 2005; Johnson et al., 2005).[6] Notably, the specific topic of director self-interest is a focus of particular attention (e.g., Ingley and van der Walt, 2004; Laby, 2004; Langbein, 2005; Pitt, 2005; Schwartz et al., 2005; for an extensive historical treatment of boards of directors, see Gevurtz, 2004). Our interest here, related to these investigations, is the question of directors' self interest and their compensation.

There has been limited research attention devoted to the intersection of directors' compensation and the potential for director self-interest. The extant work in concert, however, provides an intriguing pattern of results. Ryan and Wiggins (2004), for example, have demonstrated that boards of directors with greater numbers of outside (independent) directors award more equity-based compensation to board members. Some observers find this relationship troubling as it has been suggested that ''legitimizing the provision for large equity-based compensation might not eliminate, and could even worsen, the agency problem in the relationship between boards and shareholders'' (Bebchuk and Fried, 2004, p. 206). The self-interest aspects of directors in initial public offerings (IPOs) and their associated wealth creation has been described at length (e.g., Dalton et al., 2003c). Concerns in this context have recently been underscored by Hurt (2005, p. 711) whose work refers to the ''moral hazard and the initial public offering.''

The repricing of common stock and the board's role and proceeds in this controversial tactic have also been noted (e.g., Arya and Sun, 2004; Daily et al., 2002). The decision to reprice options is a board decision. Proponents of repricing argue that repricing will reduce CEO and top management team turnover. Derivatively, then, an increase in the performance of the firm is expected. Research evidence, however, is not uniformly supportive of this perspective (e.g., Carter and Lynch, 2004; Chen, 2004; Chidambaran and Prabhala, 2003; Daily et al., 2002). Moreover, it has been demonstrated that the timing of option repricing is suspect and seems consistently to occur just prior to events that promise to enhance the value of a repricing firm's common stock (Callaghan et al., 2004). A board's decision to reprice stock options is conspicuously awkward in a key respect. Such a decision not only addresses the shareholdings (options) of senior management but of board members as well (Bebchuk and Fried, 2004; Dalton and Daily, 2001).

Board and executive compensation

There exist a variety of similarities between board and executive compensation, including the form and function of compensation. Effective compensation systems, for example, are designed to ensure decisions are made consistent with shareholders' interests (e.g., Jensen and Meckling, 1976). Empirically we know significantly more about executive compensation, however, as this has garnered relatively more attention from researchers. Numerous studies and anecdotes, for example, highlight the relationships between CEO compensation and firms' strategies and performance (for a review, see Tosi et al., 2000).

In contrast, relatively less attention has been devoted to board member compensation. While there are clear similarities between board and executive compensation, understanding the differences between board and executive compensation is centrally important. Perhaps the chief difference is that directors are responsible for determining CEO compensation, as well as their own compensation (Dalton and Daily, 2001). In other words, no independent body oversees or ratifies the director compensation process, as is the case with CEO/executive compensation (Dalton and Daily, 2001). The one exception to this is the recent change requiring shareholder approval of certain stock-based elements of executive and director compensation plans (U.S. Securities and Exchange Commission, 2003).

That no independent body oversees the determination of director compensation creates an interesting agency problem. Becher et al. (2005) recognized this potential complexity when they observed that board members provide a critical monitoring function, and as a result, the means by which they are compensated is an important issue given the potential for agency problems between shareholders and boards of directors. Just as executives may be subject to personal incentives associated with acquisitions, directors may experience similar conflicts of interest when decisions they are responsible for ratifying or overseeing can serve as the impetus for them receiving personal benefit.

While some elements related to director compensation have been empirically examined, there is a notable aspect of directors' compensation that has received very little attention. We know, for example, that corporate acquisitions are commonplace and that such transactions require the approval of the board of directors. What remains unknown is the impact of such decisions on the compensation of the acquiring firm's board members.[7]

Directors and the corporate acquisition: growing for pay?

Director compensation may impact director independence, thereby influencing board members' ability to effectively monitor executive decision-making. Specifically, we focus on decisions to engage in acquisitions. Acquisition decisions constitute one of the more central strategic decisions made by executives (e.g., Paul, 1995; Sanders, 2001; see Hitt et al., 2001 for an excellent review of acquisition research). Importantly, boards of directors routinely ratify such decisions given their strategic importance and impact on the firm. In support of the importance of acquisitions at the board of director's level, Lorsch and MacIver (1989) noted that board involvement peaks during strategic shifts such as that of an acquisition.

The acquisition context is especially well suited for examining director effectiveness given that the majority of acquiring firms are associated with negative, not positive, firm performance. A recent meta-analysis addressed the performance of firms following an acquisition (King et al., 2004). The results are notable in their consistency. Irrespective of the post-acquisition time period (i.e., 1–5 days, 6–21 days, 22–180 days, 180 days–3 years, more than 3 years), the abnormal returns were zero or negative. The results were similar for return on assets, return on equity, and return on sales. Also, a series of tests for moderating influences (conglomerates, related transactions, method of payment [cash vs. equity], prior acquisition experience) all resulted in zero or negative abnormal returns. In summary, based on these results, it would be fair to suggest that there is little if any evidence of financial advantage for the acquiring firm.

Another interesting insight relevant to acquiring firms' directors was provided by Thompson and Thomas (2004). They reported that 80 percent of more than 1,000 fiduciary duty lawsuits filed in Delaware over a two-year period addressed a single issue – directors' decisions regarding whether or not to participate in a corporate acquisition. Research on takeovers is also informative. It has been reported that directors' decisions regarding takeovers ''were

indicative of an ulterior or self-interest motive'' (Henry, 2005, p. 157). It would appear, then, that transactions of this type are controversial and provide a context whereby directors' self-interest may supersede their duty to shareholders.

Despite a lack of evidence supporting the shareholder/firm benefits of M&A activity, acquisitions continue seemingly unabated. As regards directors, the ethical and agency issues attendant with their compensation are unique. While we know that CEO compensation increases following acquisition activity (e.g., Bliss and Rosen, 2001; Grinstein and Hribar, 2004; Khorana and Zenner, 1998; Kroll et al., 1990), we are unaware of research that empirically investigates whether director compensation also increases as a function of this strategic activity. The study we report herein provides an opportunity to enrich our understanding of the agency problem and whether and when directors are mindful of their responsibility to maximize shareholder wealth.

We extend prior research examining the relationship between executive compensation and acquisition activity to directors. Do directors have an incentive to behave unethically; i.e., in a manner that subjugates shareholders' interests to their own? Might they be compromised from their normal role as agents of shareholder's interests? Specifically, do directors benefit from acquisition activity through increased compensation? In other words, directors may have their own motives, and not necessarily those of shareholders (principals), in mind when ratifying executives' decisions and strategic options.[8]

Stated differently, directors may constitute a unique stakeholder group with their own set of interests. This would be consistent with agency theory principles and demonstrate an additional challenge in the effective governance of public corporations. As such, we hypothesize:

H1: Acquisition activity will be positively associated with subsequent outside director compensation.

Methodology

Sample

To assess the extent to which directors might benefit from strategic decisions they ratify, we relied on a matched-sample design of firms making an acquisition and a control sample of firms not engaged in an acquisition during the same time period (e.g., D'Aveni and MacMillan, 1990; Hambrick and D'Aveni, 1988). To create the list of acquiring firms, we began with the universe of firms with full director compensation data listed in *Standard & Poor*'s ExecuComp database from 1997 to 2000. We excluded all utilities and financial institutions because firms operating in these industries are subject to regulations that may influence both acquisition processes and corporate governance structures (Sanders, 2001). For each firm listed in ExecuComp over this time period, we used Securities Data Company's (SDC) online Mergers and Corporate Transactions database. We identified those firms making an acquisition whereby the value of the deal was at least 10 percent as large as the company's market capitalization. To isolate the influence of this event, we further ensured that each of the identified firms did not make an acquisition whereby the value of the deal was five percent as large as the company's market capitalization in either the year before or after the acquisition.

We then paired the sample of acquirers with control firms matched by SIC code (2-digit), sales, and year of the acquisition. We required that each control firm did not make an acquisition with a value exceeding five percent of the company's market capitalization in the year before through the year after the match's acquisition event. This matching process resulted in a final sample of 87 acquirers and 87 control firms between 1997 and 2000 (26 in 1997, 25 in 1998, 18 in 1999, and 18 in 2000). We found no statistically significant differences between firms that made an acquisition and those that did not in terms of either firm size or performance.

Variables

Dependent variable

We collected the outside director compensation measures from ExecuComp. *Total Outside Director Compensation* is calculated by adding together outside director option compensation, outside director stock compensation, and outside director cash compensation specified by the outside director compensation plan. We calculated outside director stock compensation by multiplying the number of

shares in the outside director compensation plan by the stock price at the end of the prior year. To calculate outside director stock option compensation, we relied on the Black–Scholes method. Because outside director compensation exercise prices are not listed in proxy statements, we measured the exercise price and market price as the closing prices at the end of the prior year. In other words, we assume that outside director options are granted at-the-money (i.e., the exercise price is set to the market price at the time of the option grant), a reasonable assumption since most executive stock options are granted at the market price at the time of the option grant (Datta et al., 2001). We assumed a time to maturity of ten years, a standard convention in executive compensation research (Certo et al., 2003; Datta et al., 2001; Kerr and Kren, 1992). When outside director stock or stock options compensation data were not reported, we assumed that the values were zero (Certo et al., 2003). We then took the natural log of the compensation measure.

Independent variable

As we noted previously, the final sample contains 87 acquirers and their matched firms. Given our focus on large acquisitions, we included only acquisitions with deal values exceeding 10 percent of the value of the acquiring firm. Consistent with our matched-sample design, *Acquirer* represented an indicator variable denoting whether the firm was an acquirer (1 = Yes) or a match (0 = No).

Control variables

We include a number of control variables corresponding to firms' performance, strategy, and corporate governance structures. *Total Sales* (logged) provides a measure of firm size. We include both accounting and market measures of firm performance as control variables in the models, as they may be important for both M&A activity (Sanders, 2001) and outside director compensation (Ryan and Wiggins, 2004). Specifically, we used return on assets (*ROA*) to control for operating performance and *Shareholder Return* to control for the firm's three-year total return to shareholders (including reinvested dividends). We calculated *Diversification* using a sales-based entropy measure. *Research and Development (R&D) Intensity*, which is defined as R&D expenditures divided by net sales, denotes the degree to which firms invest in innovation. *Debt-to-Equity* provides a measure of a firm's financial slack.

Finally, we include three corporate governance variables that may influence both M&A activity and outside director compensation. *Blockholder Ownership*, which serves as a proxy for a firm's ownership dispersion, represents the cumulative percentage of firm equity held by shareholders owning at least five percent of the firm's equity (Sanders, 2001). *Outside Directors* represents the proportion of non-management outsiders serving on the firm's board of directors and serves as a proxy for board independence (Sanders, 2001). We also include *Board Size* as a control, as it may influence firm strategies and performance (e.g., Dalton et al., 1999).

Analytical technique

As developed in the hypothesis, we are interested in understanding how acquisition activity influences changes in outside director compensation. Several researchers have commented on the potential problems associated with the use of change (or difference) scores as dependent variables (Allison, 1990; Edwards, 1995). Allison (1990) provides two alternatives for using difference scores as dependent variables. The first option involves using the change score (e.g., post-acquisition director compensation – pre-acquisition director compensation) as the dependent variable. In contrast to using change scores, the second approach involves using post-acquisition director compensation as the dependent variable and pre-acquisition director compensation as a control variable. According to Allison (1990, p. 106), the choice between the two alternatives ''will rarely be obvious.'' We elected to adopt the latter approach, as it is the more conservative of the two approaches.

In the regression analyses, we used Stata 8.0's ''robust'' option, which computes standard errors robust to departures from homoscedasticity. We also computed variance inflation factors (VIFs) to ensure that multicollinearity did not influence the results. In the regressions, all VIFs were less than three, which is well below the guideline of 10 advocated by Chatterjee and Price (1991).

Results

The means, standard deviations, and correlations associated with the study variables are reported in Table 1. The regression results corresponding to our empirical tests are reported in Table 2. As shown in Model 1, which includes the control variables, the most significant determinant of total compensation in the year after the acquisition was outside director total compensation in the year prior to the acquisition. Two other variables, the firm's debt-to-equity ratio and blockholder ownership, were also significantly related to total outside director compensation. In supplementary tests, we removed these lagged measures of director compensation from the models, and several additional control variables emerged as significant. This suggests that control variables are informative, but the variance attributed to the lagged measures causes them to be insignificant. As shown in Model 2, the coefficient corresponding to the acquirer dummy variable was significant and positively related to subsequent total outside director compensation ($p < 0.01$); this provides support for our hypothesis. The change in R-squared is a modest 0.02; the inclusion of prior compensation as a control variable accounted for a great deal of the variance in the dependent variable. As we discuss in the following section, however, different analytical approaches influence the resulting R-squared values.

Robustness tests

We performed several tests to examine the robustness of the reported results. We conducted supplementary tests that relied on the actual change in compensation as the dependent variable, which represents an alternative to using the lagged dependent variable as a control variable reported in the table (e.g., Allison, 1990). The results of these tests were virtually identical to those we report. Although the R-squared values were smaller for these supplementary tests, the change in R-squared associated with the independent variable was much larger. In the end, though, we believe that including the lagged value of the dependent variable as a control provides a more conservative test of the hypothesis.

We also performed supplementary analyses to examine the influence of firm size. In the reported

TABLE 1

Summary statistics

		Mean	SD	1	2	3	4	5	6	7	8	9	10	11
1	Total director compensation (Post-M&A)	6.96	2.60											
2	Total director compensation (Pre-M&A)	6.19	2.40	0.73										
3	Total sales	7.12	1.37	0.24	0.30									
4	ROA	5.15	8.70	−0.09	−0.04	0.07								
5	Shareholder return	14.21	68.49	−0.09	−0.20	−0.20	−0.07							
6	Diversification	3.46	4.63	0.00	0.11	0.27	0.00	−0.16						
7	R&D intensity	0.07	0.23	0.13	0.00	−0.21	−0.65	0.38	−0.07					
8	Debt-to-equity	−8.79	122.27	−0.07	−0.15	−0.07	0.00	0.06	−0.10	0.01				
9	Blockholder ownership	33.52	22.40	−0.24	−0.13	−0.20	0.08	0.06	−0.11	−0.09	0.07			
10	Outside directors	0.58	0.19	0.25	0.31	0.22	−0.17	−0.16	0.15	0.00	−0.12	−0.33		
11	Board size	8.92	2.74	0.16	0.17	0.63	0.02	−0.12	0.14	−0.14	−0.17	−0.23	0.27	
12	Acquirer dummy	0.50	0.50	0.14	0.03	−0.04	−0.30	−0.08	0.15	0.07	−0.08	−0.03	0.19	0.07

TABLE 2

Results of hierarchical regression analysis: the effects of M&A activity on total outside director compensation (Post-M&A)

	Model 1: Controls	Model 2: Hypothesis 1
Intercept	2.066 (1.150)	1.486 (1.009)
Control variables		
Total outside director compensation (Pre-M&A)	0.784*** (0.087)	0.786*** (0.084)
Total sales	0.060 (0.143)	0.117 (0.139)
ROA	0.014 (0.020)	0.033 (0.020)
Shareholder return	0.000 (0.003)	0.000 (0.003)
Diversification	−0.019 (0.030)	−0.032 (0.029)
Research & Development intensity	1.800 (1.269)	2.142 (1.230)
Debt-to-equity	0.001** (0.000)	0.001*** (0.000)
Blockholder ownership	−0.017* (.008)	−0.017* (0.008)
Outside directors	−0.265 (0.609)	−0.505 (0.604)
Board size	0.023 (0.072)	0.006 (0.071)
Independent variable		
Acquirer		0.804** (0.281)
F	30.30***	40.72***
Model R^2	0.583	0.603
ΔR^2		0.02

Robust standard errors are reported in parentheses.
*$p \leq 0.05$; **$p \leq 0.01$; ***$p \leq 0.001$.

model, we measured firm size in the year prior to the acquisition. In supplementary tests, we examined firm size in both the year of and the year following the acquisition. Regardless of the year corresponding to the size measure, the dummy variable distinguishing between acquirers and matched firms remained significant. This suggests that characteristics of the acquisition process other than firm size influence subsequent outside director compensation.

Discussion

We utilized agency theory to develop our hypothesis regarding acquisition activity and subsequent director compensation. Outside directors are arguably those to whom shareholders look for upholding their interests. Our analysis poses an interesting question: might directors benefit from decisions that may potentially harm other stakeholders?

Systematic examinations of director compensation packages are underrepresented in the corporate governance literature, though research in the area is gaining momentum (e.g., Becher et al., 2005; Ryan and Wiggins, 2004). Based on the analysis we report herein, there exists a positive and statistically significant relationship between acquisition activity and subsequent outside director compensation. Complementing our tests of statistical significance, we also examined the practical significance of the study results. Following the method outlined by Halvorsen and Palmquist (1980), our results indicate that the total outside director compensation packages for firms in the acquirer sample were more than twice as large as the total packages for directors in the matched sample.

More generally, we should reiterate that directors are unique with regard to corporate compensation in that they set their own salaries, authorize their own stock options, set the strike price for those options, and are even responsible for repricing these options (Bebchuk and Fried, 2004; Dalton and Daily, 2001). Beyond that, directors have decision-making authority for many transactions (e.g., stock buy-backs, the issue of restricted stock and whether such stock should be performance-based, or time accelerated) that may increase their own wealth. It is in that spirit

that we suggest that directors must be particularly sensitive to transactions of this sort—certainly including corporate acquisitions — that may so clearly suggest or be perceived as influenced by self interest. Bankowski (1997, p. 26) nicely captured this relationship between compensation and integrity:

> Probably nothing more affects the perception of fairness and corporate integrity ... than how compensation is administered. It, too, shapes our corporate character. But we can't expect individuals to make a stand for compensation ethics without a clear management and Board of Directors imperative for an ethical organization ... and where there is a fundamental commitment to conduct that is not only legal but also fundamentally fair and moral.

There is yet another aspect of director compensation/wealth that may merit comment. As noted in previous sections, much has been written about director independence and its potential to moderate the hazards of self-interest. As John Bogle, the founder of Vanguard, suggests, "However difficult spirit is to measure, board members must be independent in spirit, concerned solely with placing the interests of the owners as the overriding priority" (Bogle, 2005: 51).

Bebchuk and Fried (2004) provide an overarching, and sobering, perspective on the potential relationships among director independence, compensation, and self-interest. The essential point is that there is an underlying threat that is apparent when any practice, policy, or transaction leads to increased compensation and/or greater wealth for directors as a function of their board service. However well intentioned, incentives of this kind may have negative, unintended consequences.

> The more directors are paid, the greater is their desire to be reelected. Boosting compensation may therefore lead directors to focus not on the difficult task of increasing share value but rather on that of remaining on the board and enjoying the increased stream of compensation, as well as obtaining (now more lucrative) directorships on other boards (Bebchuk and Fried, 2004, p. 206).

Future work is needed to examine other potential issues surrounding the M&A process. For example, are the interests of executives aligned with those of directors? In other words, it may be that both executives and directors are similarly rewarded after completing M&As. In addition, how does the total wealth of directors influence these decisions? Are directors with greater personal wealth less likely to approve such decisions? Finally, what roles do hubris and social comparison play in this process? These types of data are difficult to obtain, but research examining these kinds of issues would prove beneficial to both academics and practitioners (e.g., shareholders).

Incorporating longitudinal data might also help to extend our work. Although we included several measures of prior performance as control variables, due to the nature of our sample we were unable to assess the influence of post-M&A performance measures on subsequent director compensation. Because some of these firms will successfully integrate the acquisition targets, an interesting extension might involve assessing this influence of longer-term performance on director compensation. Consistent with this premise, longitudinal data may allow researchers to examine this process in more depth.

The evidence suggests that corporate acquisitions do not benefit the shareholders of acquiring firms. Our research suggests that those transactions, however, do have a substantial positive impact on the compensation of the directors of acquiring firms. According to the results reported herein, directors appear to benefit from decisions that may potentially harm other stakeholders (e.g., shareholders). In other words, directors may constitute unique stakeholders who approve actions more consonant with their own interests than those of shareholders. Findings such as those we report are likely to, and arguably should, generate special scrutiny as boards seek the high ground that SOX, PCAOB, the listing exchanges, and their many other constituencies have staked out for them.

While our focus highlights an ethical dilemma that director's face we would be remiss not to acknowledge that many directors by and large operate often out of a sense of duty and service to others and are often aligned with their fiduciary duties. However, even if that be so, we must be sensitive to the notion that there exist disincentives to their primary mission.

Notes

[1] For an outstanding overview of the key provisions of the Sarbanes–Oxley Act of 2002, see www.

aicpa.org/info/sarbanes_oxley_summary.htm); see also, www.Sarbanes-Oxley.com, an exhaustive resource for Sarbanes–Oxley and Securities and Exchange Commission (SEC) Rules and Regulations; see especially "Newest SEC Rules and Regulations with Cross-references to Specific Sarbanes–Oxley Sections."

[2] New York Stock Exchange (NYSE) guidelines: (www.nyse.com; see especially "Final Corporate Governance Listing Standards", November, 2004).

[3] American Stock Exchange guidelines: (www.amex.com; see especially "Enhanced Corporate Governance Rules and Stock Option Plans", May 25, 2004).

[4] NASDAQ guidelines: (www.nasdaq.com; see especially "Marketplace Rules" – 2004); for a Comparison of the NASDAQ and NYSE Listing Guidelines, see "NYSE/Nasdaq Corporate Governance Listing Standards: Comparison Chart Updated" – Alston + Bird, LLP, December, 2004 (www.alston.com; under "Sarbanes–Oxley and Corporate Governance Resource Center").

[5] Strictly speaking, the audit committee is required by SOX, but is included as a requirement on the listing exchanges as well.

[6] In the last few years, there have been at least four Special Issues that have addressed directors and corporate governance – Accounting ethics (Gaa, 2004); Corporate governance: Decades of dialogue and data (Daily et al., 2003a); Governance through ownership: Centuries of practice, decades of research (Daily et al., 2003b); The Higgs Report: Implications for our understanding of corporate governance and the non-executive director (Corley, 2005).

[7] With regard to the financial impact of directors, the distinction between an "acquiring" firm and "acquired" firm in an acquisition is crucial. For directors of acquired firms, there are well-established and robust negative effects. First, board members of acquired firms are rarely retained on the board of the combined entity. As a result, the direct financial impact on outside directors in acquired firms is decidedly negative. Moreover, the displaced directors hold fewer directorships in the future compared to their control group counterparts (e.g., Harford, 2003).

[8] As a point of clarification, we should note, that our discussion of director compensation refers to outside directors. Broadly speaking, boards consist of two types of directors: inside directors and outside directors. Inside directors are employed by the focal firm, typically in a high-level executive position. Outside directors are non-management directors who are not dependent on the firm or firm management for their primary employment. We recognize that there is a distinction in boards of directors research between independent outside directors and affiliated outside directors (e.g., Johnson et al., 1996). Our intent is not to ignore this important difference; rather, for this study this distinction is less of an issue. Regardless of whether an outside (non-management) director is independent (i.e., has no ties to the focal firm other than in a director role) or affiliated (i.e., maintains some professional or personal relationship with the focal firm or firm management), all outside directors are equally compensated with regard to their board retainer. Differential payments may, however, be made for service on committees or for board leadership positions. Importantly, inside directors do not receive compensation for their service on the board. Their compensation derives from their positions as members of the firm's executive team. To avoid confusion, then, our reference to director compensation plans refers to outside director compensation plans.

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