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CEO Side Payments in Mergers and Acquisitions

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CEO Side Payments in Mergers and Acquisitions

Brian Broughman[*]

In addition to golden parachutes, CEOs often negotiate for personal side payments in connection with the sale of their firms. Side payments differ from golden parachutes in that they are negotiated ex post in connection with a specific acquisition proposal, whereas golden parachutes are part of the executive's employment agreement negotiated when she is hired. While side payments may benefit shareholders by countering managerial resistance to an efficient sale, they can also be used to redistribute merger proceeds to management. This Article highlights an overlooked distinction between pre-merger golden parachutes and merger side payments. Similar to a legislative rider attached to a popular bill, management can bundle a side payment with an acquisition that is desired by target shareholders. Thus, even if shareholders would not have approved the side payment for purposes of ex ante incentives, they may support the payment as part of a take-it-or-leave-it merger vote. Because side payments are bundled into merger transactions, voting rights cannot adequately protect shareholders against rent extraction. My analysis helps explain empirical results, which show that target CEOs sometimes bargain away shareholder returns in exchange for personal side payments. I conclude with legal reforms to help unbundle side payments from the broader merger vote.

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[*] Professor of Law, Indiana University Maurer School of Law. For helpful conversations and comments on earlier versions of this paper, I am grateful to Afra Afsharipour, Steven Davidoff, Lisa Fairfax, Jesse Fried, Mike Gilbert, Chris Montagano, Donna Nagy, Andrew Tuch, and seminar participants at UCLA, USC, Colorado, and the 2014 National Business Law Scholars Conference. I would also like to thank Meg Burton, Josh Victor, and Daniel Cyr for valuable research assistance.

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I. INTRODUCTION

In connection with its 2005 acquisition of The Gillette Company, Procter & Gamble offered temporary employment plus a side payment worth approximately $23 million to Gillette's then-CEO, James M. Kilts.[1] The side payment was structured as a non-compete agreement, and it was in addition to the change of control payouts ("golden parachutes") included in Mr. Kilts's pre-merger employment contract.[2] Mr. Kilts was the primary individual negotiating on behalf of Gillette.[3] The merger proposal, which included an 18% premium for target shareholders,[4] was ultimately endorsed by Mr. Kilts, unanimously supported by Gillette's board of directors,[5] and approved by 96% of the firm's voting shareholders.[6]

Though the magnitude of benefits received by Mr. Kilts is unusual,[7] the basic use of side payments is not. In acquisitions of both privately- and publicly-held firms, it is common for acquirers to offer the CEO (and sometimes other top executives) of the target firm either post-merger employment or some form of side payment.[8] Side payments are structured in a variety of different ways, including (i) merger bonuses (often structured as non-compete agreements); (ii) augmented parachute entitlements; (iii) employment or post-merger consulting contracts; (iv) 'unscheduled' stock options during merger

1. Gillette Co., Proxy Statement (Schedule 14A) I-67 (May 25, 2005).

2. *Id*. at I-66 to I-67.

3. *See id*. at I-22 to I-25.

4. Lloyd Vries, *Procter & Gamble Acquires Gillette*, CBS MONEYWATCH (Jan. 28, 2005), http://www.cbsnews.com/news/procter-gamble-acquires-gillette/.

5. *Id*.

6. *Procter and Gillette Shareholders Approve $57 Billion Merger*, N.Y. TIMES (July 13, 2005), http://www.nytimes.com/2005/07/13/business/procter-and-gillette-shareholders-approve-57-billion-merger.html.

7. *See* Charles Forelle & Mark Maremont, *Gillette CEO Payday May Be Richer*, WALL ST. J. (Feb. 3, 2005), http://www.wsj.com/articles/SB110738943232044343 (summarizing the benefits awarded to Kilts).

8. *See infra* notes 30–37 and accompanying text. Side payments are not limited to the target CEO. Other members of the target firm's senior management team sometimes receive side payments as well; however, to facilitate meaningful comparisons empirical studies typically focus on the CEO. *See id*. To the extent that other members of senior management are involved in merger negotiations the analysis in this Article applies to such individuals as well as to the CEO. For ease of terminology and to track existing data, however, I will typically refer to the target CEO rather than to the loose collection of target managers involved in merger negotiations who happen to receive side payments.

negotiations; or (v) a board seat with the acquiring firm.[9] The dollar amounts paid out in such side deals are substantial. CEOs of publicly-held target firms typically receive a larger aggregate payout from merger side deals ($2 million)[10] than from pre-merger golden parachute arrangements ($1.5 million).[11]

On the one hand, side payments may benefit shareholders by countering managerial resistance to an efficient sale. Because an acquisition is likely to cause the target CEO to lose her job, future income, and various private benefits, she may credibly threaten to block the sale unless she is offered post-merger employment with the acquiring firm or a lucrative side payment to compensate for her loss. To be sure, support of management is not technically required to sell a firm. But as a practical matter, it is difficult to sell over the objections of the CEO and senior management. The CEO is typically the primary party negotiating the deal on behalf of the target, and even when this is not the case, an uncooperative management team may destroy considerable value that the acquirer hopes to gain from the deal, suggesting that all parties can benefit from a well-structured side payment. Viewed in this light, merger side payments can help counteract managerial entrenchment and align the interests of the CEO with shareholders ("Incentive Alignment").[12]

Alternatively, there is a risk that side payments may be used to enrich the CEO at shareholders' expense ("Rent Extraction").[13] The target CEO—acting as bargaining agent for the corporation—may accept a lower merger premium in exchange for personal gain through a side payment that does not benefit shareholders as a class. Empirical studies have found lower acquisition premiums associated with mergers in which the target CEO receives a side payment.[14] Furthermore, some forms of side payments are associated with

9. *See infra* Part II.

10. *See infra* notes 37–45 and accompanying text. This may understate the benefits that CEOs receive from merger side payments, as it does not include the value of post-merger employment with the acquiring firm. Including an estimated value for post-merger employment suggests that target CEOs receive an average benefit of approximately $4.3 million from merger side deals. *Id.*

11. *See infra* Table 1.

12. *See infra* Section III.A.

13. *See infra* Section III.B.

14. *See infra* Section III.B.

abnormal positive returns for the acquiring firm, suggesting collusion between the target CEO and acquirer in pricing deals.[15]

Despite this evidence, legal scholars have given little attention to problems associated with merger side payments. Presumably one reason for this omission is that the law already requires that any extra benefits—including side payments—received by senior management in an acquisition be disclosed to shareholders and that the entire transaction be subject to both board *and* shareholder approval.[16] Informed shareholder approval generally mitigates concern related to conflicts of interest.[17] Given these procedural safeguards, why do empirical studies nonetheless find evidence of rent extraction? Put another way, why would a target's shareholders and board of directors vote to approve a merger that gives money away to the CEO? The existing literature in both law and finance does not have a good answer to this question.

Addressing this gap, I propose a new theory for merger side payments that explains why rent extraction persists despite existing legal protections for shareholders. While a typical agency conflict is driven by shareholders' inability to observe bad behavior and lack of incentive to monitor management, merger side payments present a different problem. Similar to a legislative rider attached to a popular bill, management can use its agenda-setting power to bundle a side payment with a sale of the firm that is desired by target shareholders. Shareholders cannot oppose the side payment unless they are willing to block the entire deal and give up the acquisition premium associated with the sale.[18] Disclosure and voting rights do not help. Indeed, even if shareholders would not have approved the side payment for purposes of ex ante incentives, the payment may rationally receive ex post shareholder support as part of a take-it-or-leave-it merger vote.

15. *See infra* Section III.B.

16. STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 50 (3d ed. 2012).

17. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(2) (2016). In fact, shareholder approval is one reason that merger side payments are often entitled to protection under the business judgment rule. *See id.*; *see also infra* Section III.C.

18. Acquisitions typically occur at a significant premium above the pre-deal share price. *See, e.g.*, Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSPECT. 103, 106 (2001) (showing an average median premium between 34% and 47%).

My analysis highlights an important but overlooked distinction between golden parachutes and merger side payments. Golden parachutes are part of an executive's employment agreement negotiated at the time she was hired; they are not linked to a specific acquisition. While a parachute may change the threshold level at which a CEO is willing to support a sale of her firm, it does not create a conflict with respect to the CEO's negotiation of merger premium.[19] The CEO still has every incentive to bargain for a high shareholder premium. By contrast, side payments create an incentive for the CEO to trade away shareholder premium in exchange for a larger side payment. Consistent with this distinction, empirical studies find more evidence of rent extraction associated with side payments than with golden parachutes.[20]

Legal and extra-legal constraints limit, but do not remove, rent extraction.[21] For example, an auction may force an acquirer to devote its funds to shareholder premium and the threat of tax penalty may limit side payments over a threshold level.[22] Nonetheless, these constraints are incomplete and unable to eliminate the risk of rent extraction. Indeed, as long as side payments are disclosed to shareholders, corporate law largely shields them from judicial review, giving shareholders little ability to counteract the CEO's agenda-setting power.[23]

I conclude by proposing a small reform to corporate law to help unbundle side payments from the broader merger vote. In particular, firms should be permitted to opt into a heightened fiduciary standard by placing language in the firm's charter requiring that any side benefit received by the CEO and possibly other members of senior management, must be approved by a separate vote, upon which the broader acquisition cannot be contingent. To avoid the possibility that shareholders may decline to approve an ex post side payment, firms selecting this option would be encouraged to address the problem ex ante by adopting golden parachutes and related agreements. I explain

19. *See infra* note 112.

20. *See infra* notes 111–114, 118–121 and accompanying text.

21. The prospect of a second bidder may limit excessive side payments because such payments would divert funds away from the purchase price and thereby place the original bidder at a competitive disadvantage in any resulting auction for the target. This constraint, however, is only binding to the extent that there are multiple parties who might bid for the target firm. *See infra* Section V.A.

22. *See infra* Section V.B.

23. *See infra* Section V.D.

how this proposal could reduce the CEO's agenda-setting power with respect to side payments, while still giving firms flexibility to compensate CEOs for negotiating a sale of the business.

The remainder of this Article is organized as follows. Part II describes empirical studies of merger side payments in connection with the sale of publicly- and privately-held firms. Part III considers two explanations for the use of side payments: incentive alignment and rent extraction. Part IV develops a new theory for rent extraction through bundled side payments. Specifically, it demonstrates that target CEOs can use control over the corporate agenda to bundle an opportunistic side payment into a desired merger transaction, thereby making it impossible for target shareholders to oppose the side payment without also voting against the merger. Part V considers legal and extra-legal constraints that may limit merger side payments. Part VI proposes a small change to corporate law to help unbundle side payments from the broader acquisition. Part VII concludes.

II. EVIDENCE OF MERGER SIDE PAYMENTS

While an acquisition may cause the target CEO to lose her job and reduce her future income, it can also provide her with a variety of financial benefits. The first comprehensive study of the various benefits—including side payments—that CEOs of publicly-held targets receive in connection with the sale of their firms was conducted by Jay Hartzell, Eli Ofek, and David Yermack; their study is based on data from the sale of 311 publicly traded targets in the late 1990s.[24] For privately-held targets, the only empirical work documenting side payments is my own research with Jesse Fried,[25] which is based on the sale of 50 startups in the early 2000s.

Side payments are not the only type of benefit that target CEOs receive when their firms are sold. Executives, like other shareholders, also receive any premium applied to their equity in the target firm. For example, an acquirer may be willing to pay $40 per share for a target firm that had been trading for $30 per share prior to the acquisition,

24. Jay C. Hartzell, Eli Ofek & David Yermack, *What's in It for Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD., Jan. 2004, at 37, 41 [hereinafter Hartzell].

25. *See generally* Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319 (2013) [hereinafter Broughman & Fried, *Carrots and Sticks*]; Brian Broughman & Jesse M. Fried, *Renegotiation of Cash-Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384 (2010).

a 33% premium over the pre-existing share price. Combining stock and option gains, the average target CEO receives equity appreciation of just under $5 million when her firm is sold.[26] This amount does not include the base value of the CEO's equity holdings prior to the announcement of the acquisition. It only measures the premium applied to the CEO's equity. Most CEOs also receive a substantial change of control payout, or "golden parachute" (averaging $1.5 million),[27] based on their pre-merger employment contracts.

Side payments are, however, a substantial component of the merger benefits that a target CEO typically receives. Merger side payments are extra amounts given to the target CEO that are negotiated *in connection with* a specific merger transaction. These benefits did not exist, even as contractual entitlements, prior to the negotiation of the merger. Other members of the target's senior management team may also receive side payments;[28] however, to facilitate comparison, empirical studies typically focus on the CEO.[29]

Existing studies document four general categories of merger side payments. First, parachute payments are sometimes "augmented by the target's board of directors *at the time that it approves the merger*."[30] Though technically structured as a golden parachute, this benefit functions as a merger side payment since it was negotiated in connection with a specific merger deal. The average target firm CEO who received this benefit was awarded $3.3 million, but since only 12% of target firm CEOs received an augmented parachute, the average payout for the entire population of target firm CEOs is $400,000 (= $3,300,000 x 0.12).[31]

26. *See* Hartzell, *supra* note 24, at 45.

27. *Id.* (finding that 69% of the CEOs in their sample had golden parachute arrangements in place at least a year prior to the acquisition. For tax reasons, the golden parachute payment is typically equal to three times the CEOs salary and bonus in the years prior to the deal. I.R.C. § 280(G) (2012) limits corporate deductions for golden parachute payments to this amount).

28. *See, e.g.*, Gillette Co., Proxy Statement (Schedule 14A) I-67 to I-68 (May 25, 2005) (describing equity awards and retention agreements given to four senior executives of Gillette in addition to the CEO, Mr. Kilts).

29. *See infra* notes 30–42 and accompanying text.

30. *See* Hartzell, *supra* note 24, at 46 (emphasis added) ("In these cases, boards vote to increase the CEO's parachute value and shareholders learn of the change after the fact from an SEC filing; a little more than half of this subgroup did not have any parachute in place prior to the augmentation.").

31. *See id.*

Second, target CEOs may receive payment from the acquirer for post-merger consulting or for signing a non-compete agreement.[32] Finance studies refer to such payments as "merger bonuses."[33] The average target firm CEO who received a merger bonus was awarded $4.4 million; this benefit was received by 27% of target firm CEOs, implying that the average merger bonus payout for the entire population of target firm CEOs is $1.2 million (i.e. 1,200,000 = 4,400,000 x .27).[34]

Third, the target board may grant *unscheduled* stock options to its CEO *during* merger negotiations.[35] While option grants in other contexts can have incentivizing effects when awarded in connection with a merger proposal, such grants function as an alternative form of side payment. The average target firm CEO who received an unscheduled option during deal negotiations was awarded an extra $3.5 million; this benefit was received by 13% of target firm CEOs, implying that the average value of unscheduled options granted during deal negations for the entire population of target firm CEOs is $455,000 (= $3,500,000 x 0.13).[36]

Fourth, many target CEOs receive either continued employment (50%) or a board seat (57%) with the acquiring firm.[37] Such benefits are explicitly negotiated in connection with the M&A deal. As a prominent New York lawyer explained, "I have had a number of situations where we've gone to management looking to do a [merger] and been stopped at the door until a compensation arrangement was signed, sealed and delivered[.]"[38] CEOs who are retained by the

32. *Id.*

33. *Id.* at 54.

34. *See id.* at 46 (calculated by multiplying $4,400,000 by 0.27); *cf.* Eliezer M. Fich, Edward M. Rice & Anh L. Tran, *Contractual Revisions in Compensation: Evidence from Merger Bonuses to Target CEOs*, 61 J. ACCT. & ECON. 338, 345 (2016) [hereinafter Fich, *Contractual Revisions*] (finding that 23% of target CEOs receive a merger bonus by using a larger dataset of M&A deals; the mean merger bonus payout in their study was $1.6 million).

35. Eliezer M. Fich, Jie Cai & Anh L. Tran, *Stock Option Grants to Target CEOs During Private Merger Negotiations*, 101 J. FIN. ECON. 413, 419 (2011) [hereinafter Fich, *Option Grants*].

36. *Id.* (finding, when using data from 920 acquisitions conducted from 1999 to 2007, that the rate of unscheduled option grants during merger negotiations (13%) is significantly higher than the baseline rate of unscheduled stock option grants (9%)).

37. *See* Hartzell, *supra* note 24, at 46–47.

38. Andrew Ross Sorkin, *Executive Pay: A Special Report; Those Sweet Trips to the Merger Mall*, N.Y. TIMES (Apr. 7, 2002), http://www.nytimes.com/2002/04/07/business/executive-pay-a-special-report-those-sweet-trips-to-the-merger-mall.html.

acquiring firm typically receive a larger salary (18% greater) and a larger bonus (34% greater) than they did with the target firm.[39]

Conceptually, a CEO retention agreement should only be treated as a side payment to the extent that the executive is overpaid relative to any value she creates for the acquiring firm. Because the retained individual presumably adds value to the acquirer and the total benefits that the individual may receive under such agreement are unknown at closing, it is difficult to measure the side payment component of a retention agreement. Target CEOs who obtain a position as an officer of acquiring firms receive "about $4.7 million less in negotiated cash pay from golden parachute augmentations and special merger bonuses."[40] "These results imply that acquirers overtly pay certain CEOs to surrender managerial control over their firms' assets, or equivalently, that some CEOs 'purchase' executive jobs in the buyer by foregoing cash payments that they might otherwise have obtained."[41]

Target CEOs generally receive *either* post-merger employment or a side payment.[42] This suggests that the average CEO values continued employment at approximately $4.7 million. Though this figure may seem high, it is consistent with evidence that departed CEOs often do not find subsequent work, or find work at a substantially lower-paying job.[43] Given that 50% of target CEOs receive continued employment, the mean value of continued employment for the full population of target-firm CEOs may be approximately $2.35 million (50% of $4.7 million).

Putting this together, we can estimate the aggregate value of merger side payments for CEOs of publicly-held targets. Excluding the value of benefits received by CEOs retained by acquirers, the mean CEO receives just over $2 million in merger side payments. If we include acquirer retention agreements (valued as above), the mean CEO can expect approximately $4.3 million in merger side benefits. Either way merger side payments are an economically significant

39. Hartzell, *supra* note 24, at 48. Many of target CEOs do not stay with the acquirer for even a full year after the merger, and when they depart they typically receive a lucrative severance payment (mean of $3.8 million) from the acquirer. *Id.* at 49.

40. *Id.* at 54.

41. *Id.* at 39.

42. *See id.*

43. *See id.* at 49–55; Anup Agrawal & Ralph A. Walkling, *Executive Careers and Compensation Surrounding Takeover Bids*, 49 J. FIN. 985, 985–1014 (1994).

payout, larger than the average value paid out under pre-merger parachute arrangements ($1.4 million).[44] These results are summarized in Table 1.

Due to limited data availability for privately-held firms, there is less evidence on the use of merger side payments in private acquisitions. One exception to this is my own research with Jesse Fried.[45] We used interviews to collect information related to the acquisition of 50 venture-backed startups. We found that the CEO received a non-retention merger bonus in 16 of the 50 acquisitions.[46] For our full sample, the average merger bonus was approximately $0.5 million (or $1.6 million for the 16 deals that provide a merger bonus).[47] In dollar terms, the merger bonuses that we find in private acquisitions are modest, at least as compared to public deals. However, when computed as a fraction of the acquisition price, these are large bonuses (for the 16 deals which provide a merger bonus, the bonus was 6.6% of the total sale price). We also found that top executives of the target firm were offered retention contracts in 38% of the acquisitions in our study.[48] While the generalizability of our study—involving only VC-backed startups—to all private acquisitions may be questioned, our research at least shows that merger side payments are not limited to public acquisitions and can be a significant source of compensation for executives of private as well as public targets.

44. *See* Hartzell, *supra* note 24, at 45. Hartzell et al. collect data from SEC filings made in connection with the sale of each of these firms. This lets them measure various payouts that the CEO of the target firm receives in connection with the sale. *Id.*

45. Broughman & Fried, *Carrots and Sticks*, *supra* note 25.

46. *See id.* at 1351.

47. *See id.* at 1350.

48. *See id.* at 1351 n.91 (reporting that 19 founders (i.e. 38% of the 50 firm sample) received a retention agreement from the acquirer).

Table 1: Benefits Received by CEOs of Publicly-Held Targets[49]

PRE-MERGER BENEFITS

Type	%	Mean $ Value	Source
Share gains	n/a	4,247,863	Hartzell, et. al. (2004)
Option gains	n/a	656,451	Hartzell, et. al. (2004)
Parachute	69.0	1,465,251	Hartzell, et. al. (2004)
Total		**$6,369,565**	

MERGER SIDE PAYMENTS

Type	%	Mean $ Value	Source
Monetary Benefits			
Augmentation of parachute	12.1	393,545	Hartzell, et. al. (2004)
Additional bonus	27.2	1,201,011	Hartzell, et. al. (2004)
Unscheduled Option	13.0	455,000	Fich, et. al. (2011)
Other Merger Benefits			
CEO retained as officer	50.3	n/a	Hartzell, et. al. (2004)
CEO retained as director	57.1	n/a	Hartzell, et. al. (2004)
Total (excluding retention)		**$2,049,556**	
Total (including retention)[50]		**$4,349,556**	

49. Table 1 lists benefits—financial and otherwise—received by the CEO in connection with the sale of her firm. Data is from Hartzell, *supra* note 24, at 44–46 (including 311 acquisitions involving publicly held firms from 1995 to 1997), and from Fich, *Option Grants*, *supra* note 35 (including 920 acquisitions involving publicly held firms from 1999 to 2007).

50. For a discussion of the value of continued employment, see *supra* note 40–43 and accompanying text.

III. TWO EXPLANATIONS: INCENTIVE ALIGNMENT AND RENT EXTRACTION

More difficult than showing the existence of merger side payments is determining whether target shareholders benefit from these arrangements. This Part considers two alternative explanations for the frequent use of merger side payments: *incentive alignment* and *rent extraction*.

A. Incentive Alignment

A side payment may benefit shareholders by countering managerial resistance to an efficient sale. To illustrate, consider the following hypothetical.

Suppose Target has 10 million shares outstanding that are currently trading for $40/share (market cap = $400 million). Acquirer is considering buying Target for strategic purposes. Due to expected synergies, Acquirer would be willing to pay up to $500 million for Target, producing a net gain in social welfare equal to $100 million.

Though not technically required, assume a deal—and the accompanying social gain—can only go forward with the support of the CEO of Target. The CEO will support an acquisition only if it is in her personal interest to do so. As is typical, the CEO is the primary party negotiating the deal on behalf of Target and if she threatens to hold up the deal, the parties believe that considerable value would be lost. Consequently, Acquirer is only interested in buying Target with the CEO's support.[51]

Suppose the CEO holds 1% (100,000 shares) of Target's outstanding equity, currently valued at $4 million (100,000 x $40/share). The CEO also values her job. Assume a $3 million buyout is the minimum payment that the CEO would voluntarily accept to give up her employment position at Target. This figure reflects the marginal value to the CEO of her job (including future compensation, private benefits, status, etc.) relative to her next best employment opportunity. Putting her share value together with her

51. Alternatively, we could instead assume that a deal remains possible, but that Acquirer would only be willing to pay a smaller amount if a deal is done without the CEO's support. This may limit the magnitude of side payment that a CEO can bargain for, since Acquirer could threaten to do the deal without the CEO if the CEO makes unreasonable demands. Nonetheless, the basic intuition regarding incentive alignment remains valid because the CEO could still hold up the deal to the extent that it is worth more with her cooperation.

employment value, the CEO will only support a sale if she receives at least $7 million from the deal. This follows since the sale will require the CEO to give up both her equity holdings (worth $4 million) and her job (worth $3 million). The benefit to the CEO could come from either (i) the price offered to Target shareholders (i.e., the merger premium), or (ii) from a side payment offered to the CEO. For ease of analysis, I assume the CEO is not entitled to a golden parachute.[52]

Given this setup, we can explore the effect of side payments on merger negotiations. Without a side payment, the only benefit that the CEO receives from a sale is the premium offered for her shares. The shareholder premium, however, would need to be very large to compensate the CEO for giving up her job. In the current example, the CEO would need to receive $7 million for her 1% equity interest in Target, meaning Acquirer would need to pay $700 million (or $70/share) for the entire company. Unfortunately, Acquirer only values Target at $500 million. At this price, the CEO would only receive $5 million for her equity. Without a side payment the CEO will block the sale of Target. The result is entrenchment. Society loses out on the $100 million surplus that a sale would create.

It is easy to see that a merger side payment could solve this problem. For example, a side payment equal to exactly $3 million would fully compensate the CEO for giving up her job, and align the CEO's incentives with those of shareholders. With this side payment, the CEO's marginal welfare in any merger negotiations would depend solely on the price paid to Target shareholders. This is also the standard justification for golden parachutes. The idea is to remove the entrenchment motive by fully compensating the CEO for her loss of position, and thereby encourage the CEO to focus on shareholder welfare.

In the current example, a $3 million side payment makes an acquisition possible. For instance, Acquirer may offer to buy Target for $480 million (or $48/share) and give CEO a $3 million side payment. Acquirer would be paying a total of $483 million for a company that it values at $500 million. The CEO would receive $7.8 million in total benefits from the deal ($3 million side payment plus $4.8 million for her equity), giving her a small gain relative to her

52. Furthermore, for simplification, I assume Acquirer would not receive any extra value from getting the CEO to sign a retention agreement or a non-compete agreement. Put differently, Acquirer simply needs to get the CEO to support the sale, but the structure of any side payment offered to the CEO does not impact merger surplus.

prior status; and Target shareholders would receive a 20% merger premium, a gain of $80 million ($480 million compared to $400 million market cap). To be sure, a small portion of the merger surplus ($3 million) is necessarily being redirected to the CEO, but compared to no deal this is a definite improvement for Target shareholders,[53] and it preserves the social benefit created by the acquisition.

Some may find this explanation of incentive alignment troubling because it includes payments for conduct that a CEO acting on shareholders' behalf ought to perform regardless of financial incentives. At least in spirit, fiduciary obligations suggest that the CEO ought to support a sale of Target whenever it is in the best interests of Target shareholders. In response, it should be noted that the CEO's conflict is unusual in that serving the shareholder interest could mean giving up her personal livelihood. Outside of corporate law, fiduciary relationships do not generally require the agent to sacrifice her career for fiduciary ends.[54] Furthermore, while blocking an acquisition may be against the spirit of fiduciary law, it is difficult to enforce this obligation in the M&A context. Management could always claim that the reason they are blocking the sale is that the price offered to target shareholders is too low.[55] Given the various methods of valuing a business[56] and the wide degree of discretion afforded management in opposing a takeover, this defense is difficult for an objecting shareholder to overcome. Thus, even if extracting a merger

53. Indeed, the CEO's loss of $3 million in private benefits by giving up her job should be included in a full social-welfare analysis, meaning this hypothetical merger only creates $97 million in true social gain, all of which is going to the shareholders—$17 million to the Acquirer shareholders (in the form of savings on the transaction purchase price) and $80 million to Target shareholders. The $3 million side payment is merely compensating for the CEO's loss of private benefits.

54. For example, employees are agents of their employer and consequently owe fiduciary obligations to the employer. Yet, an employee is not obligated to cease working for the employer based on belief that someone else may be more qualified for the job.

55. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949–53 (Del. 1985) (discussing where the target board rejected the acquirer's two-tiered tender offer, finding, after deliberating reasonably and in good faith, that the offer was coercive and inadequate); *see also* Miguel Helft & Andrew Ross Sorkin, *Yahoo Rejects Microsoft Bid Again*, N.Y. TIMES (Apr. 7, 2008), http://www.nytimes.com/2008/04/07/technology/07cnd-soft.html?_r=0 (reporting that Yahoo rejected Microsoft's second takeover offer, deeming the bid to be insufficient).

56. Various methodologies for valuing a business include (without limitation): discounted cash-flow analysis, comparable company analysis, comparable transaction analysis, ratio analysis, asset valuation, and weighted-average approaches. For a discussion of such methodologies in the context of appraisal litigation, see Rutherford B. Campbell Jr., *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1, 13–18 (2003).

side payment may seem improper, practically speaking it makes sense to think of the payment as serving an incentive alignment function.

Empirical studies suggest that side payments are indeed used for incentive alignment. Side payments arise more often in settings where the CEO's loss of private benefits creates heightened incentives to otherwise block the merger.[57] For example, if the Target CEO is not retained or her employment agreement provides below average change of control benefits, she is more likely to receive a merger side payment, and the value of such payment will be larger.[58] Merger side payments may "act as a form of ex-post settling up . . . whereby target CEOs are made whole for the benefits they lose when firms are sold."[59] According to estimates from Fich, Rice, and Tran, "a $1 decline in the parachute payment raises the [merger] bonus by $0.67."[60] One interpretation consistent with such data is that CEOs with inadequate change-of-control protection require a larger side payment to align their incentives with those of shareholders.[61] Collectively, these results suggest that side payments are often used to overcome managerial entrenchment that could otherwise derail an acquisition.[62]

B. Rent Extraction

A side payment can be understood as a renegotiation of the CEO's employment contract. In the contract theory literature, renegotiation

57. *See* Hartzell *supra* note 24, at 40; *see infra* notes 57–61 and accompanying text.

58. *See* Hartzell, *supra* note 24, at 39 ("[W]e find strong inverse associations between [side payments] and the likelihood that the target CEO remains as an officer of the acquirer."); *see also* Fich, *Contractual Revisions*, *supra* note 34, at 365 (explaining that in low synergy targets, side payments provide an adjustment to the compensation received by target CEOs in takeovers). Also, there is some evidence that merger side payments are positively correlated with prior excess compensation.

59. *See* Hartzell, *supra* note 24, at 39 (citing Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288 (1980)) (internal quotations omitted).

60. *See* Fich, *Contractual Revisions*, *supra* note 34, at 347.

61. *Id.* at 339, 341 (explaining side payments "may resolve the potential conflict of interest between the CEO and shareholders. In this situation, an extra cash benefit provided during an acquisition attempt can move the target CEO to support and enable a deal the CEO would otherwise oppose.").

62. As further evidence of this, even with widespread use of side payments, shareholders of target firms as opposed to acquirers appear to capture almost all of the gains associated with merger activity. *See* Andrade, Mitchell & Stafford, *supra* note 18, at 110 (showing that target firm shareholders receive all of the economic gains associated with merger activity and acquiring shareholders receive no benefit and in some periods even receive negative returns).

is a standard solution to holdup problems.[63] Provided the parties are not constrained by wealth, renegotiation will ensure an ex post efficient outcome.[64] Renegotiation, however, may have distributive consequences, and can lead to inefficient investment behavior ex ante.[65] Applied to the current context, the parties use a form of Coasian bargaining to negotiate around the CEO's holdup, ensuring efficient ownership of the Target firm.[66] The side payments needed to reach this result, will lead to a redistribution of merger surplus away from Target shareholders and to the benefit of the Target CEO (and possibly the Acquirer).

In the hypothetical in Section III.A, the merger surplus is not redistributed because it is assumed that the CEO will simply receive the minimum side payment necessary to achieve incentive alignment. But this need not be the case. Indeed, the CEO and Acquirer have an incentive to collude in the design of the side payment and pricing of the merger. This incentive occurs because for each additional dollar paid to Target shareholders, the CEO only receives $0.01 (her 1% pro rata interest). By contrast, the CEO receives 100% (minus taxes) of each dollar allocated as a side payment. The Acquirer can obtain the CEO's consent at a much lower cost by allocating more of the funds to the side payment and less to the Target shareholders. The parties, of course, cannot set the merger price so low that Target shareholders might reject the offer, but they can capture a larger portion of the surplus.

To illustrate with an example, consider the following extension of the hypothetical. Instead of a $3 million side payment, the Acquirer could offer a $13 million side payment in exchange for lowering the purchase price from $480 million to $460 million. These terms make both Acquirer and Target CEO better off, as compared to the arrangement above. The CEO now gets $17.6 million, as compared

63. *See* Brian Broughman, *Investor Opportunism, and Governance in Venture Capital*, *in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 347, 350 (Douglas Cumming ed., 2010) (discussing the use of renegotiation as a solution to problems created by opportunism and ex post hold-up).

64. *See id.*

65. *See id.*

66. *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON., Oct. 1960, at 1, 1–44. In the current example, the CEO of the target firm has something akin to a property right over the assets of the target firm, suggesting that the CEO's consent is needed to transfer these assets to the acquirer.

to $7.8 million above,[67] and Acquirer pays a total of $473 million instead of $483 million. Target shareholders are the only group harmed by this arrangement; instead of $480 million they now receive $460 million. The quid pro quo in this bargain may not be explicit, as counterfactual offers may not be observed. Nonetheless, it is easy to see how a CEO's bargaining incentives may be compromised by a large side payment.

Table 2 provides a summary of the expected payoffs to each party under the various arrangements described above. The first row shows that without a side payment there is no merger and the parties fail to capture any benefit. The last two rows show the division of merger surplus under the two hypothetical deals described above. To avoid double counting, the last column excludes the CEO's payoff as shareholder, and only counts the value of the side payment minus the loss of the CEO's current job at Target.

Table 2: Merger Payoffs with Alternative Side Payments

		Marginal Payoff to Each Party		
Side Payment	**Merger Price**	**Acquirer**	**Target SHs**	**Target CEO**
None	Deal blocked	0	0	0
$3M	$480M	$17M	$80M	0
$13M	$460M	$27M	$60M	$10M

Empirical studies of side payments find evidence of rent extraction. Numerous studies find that the premium offered to target shareholders is significantly lower in deals where the target CEO receives either a side payment or post-merger employment.[68] In a

67. The CEO receives $4.6 million for her 1% equity interest, plus a $13 million side payment.

68. Numerous publications establish evidence that side payments lead to a lower premium. *See, e.g.*, Fich, *Option Grants*, *supra* note 35; Hartzell, *supra* note 24; Buhui Qiu, Svetoslav Trapkov & Fadi Yakoub, *Do Target CEOs Trade Premiums for Personal Benefits?*, 42 J. BANKING & FIN., May 2014, at 23. Additionally, several studies evidence that post-merger employment leads to a lower premium. *See, e.g.*, Hartzell, *supra* note 24; Qiu, Trapkov & Yakoub, *supra* 68; Julie Wulf, *Do CEOs in Mergers Trade Power for Premium? Evidence from "Mergers of Equals*," 20 J. L. ECON. & ORG. 60 (2004). *But see* Leonce L. Bargeron, Frederik P. Schlingemann, René M. Stulz & Chad J. Zutter, *Do Target CEOs Sell Out Their Shareholders to Keep Their Job in a Merger?* (Nat'l Bureau of Econ. Research, Working Paper No. 14724, 2009),

recent finance study, for example, the authors found that target shareholders receive a 5% lower merger premium when the CEO is offered employment by the acquirer.[69] Similarly, "targets granting their CEOs unscheduled stock options while confidential merger talks are in progress earn acquisition premiums about 4.4 percentage points lower."[70] Furthermore, side payments cost target shareholders more than they benefit the target CEO,[71] suggesting that target CEOs are in essence colluding with the acquirer to redistribute a portion of target shareholder gains between them.[72]

The existence of lower merger premium in deals that involve a side payment or CEO retention does not necessarily imply rent extraction. It may be that side payments are endogenous to low-quality targets and deals with low-potential synergies. A buyer can offer a larger shareholder premium as the merger surplus (i.e. synergy) increases. Consequently, in an acquisition that creates a large surplus, the CEO may support the deal even without a side payment because the premium applied to her equity holdings fully compensates her for the loss of her job. Conversely, if an acquisition involves a small surplus the opposite is true and a side payment may now be necessary to obtain the CEO's support. Consistent with this, one type of side payment—merger bonuses—is more common in deals with a low merger synergy.[73] The low synergy explanation, however, does not apply to other types of merger side payments.[74] In a study that addresses the endogeneity of CEO retention, Qiu, Trapkov, and

http://www.nber.org/papers/w14724 (finding that post-merger employment does not lead to a lower merger premium). Another refinement on this basic result comes from Hartzell, *supra* note 24, at 58 (finding evidence that target CEOs holding less than the median amount of equity in the target firm are more likely to sacrifice equity appreciation for personal benefit). This result suggests that a CEO's pre-merger equity holdings can serve as a partial constraint on rent extraction.

69. *See* Qiu, Trapkov & Yakoub, *supra* note 68, at 28.

70. Fich, *Option Grants*, *supra* note 35, at 414.

71. *See generally* Fich, *Option Grants*, *supra* note 35; Hartzell, *supra* note 24; Qiu, Trapkov & Yakoub, *supra* note 68; Wulf, *supra* note 68.

72. Fich, *Option Grants*, *supra* note 35, at 414 (finding that "[d]eal value is reduced by almost $62 for every $1 of profit target CEOs obtain from unscheduled stock options."). *But see* Shane Heitzman, *Equity Grants to Target CEOs During Deal Negotiations*, 102 J. FIN. ECON. 251–52 (2011) (finding no evidence of rent extraction through side payments).

73. *See generally* Fich, *Contractual Revisions*, *supra* note 34, at 338.

74. *See generally* Fich, *Option Grants*, *supra* note 35 (discussing unscheduled stock options to target CEOs in mergers); Hartzell, *supra* note 24 (examining the benefits received by target CEOs in completed mergers and acquisitions).

Yakoub still find a strong negative correlation between CEO retention and merger premium, suggesting that this result is not driven by selection bias.[75] Rather, retained CEOs do not seem to bargain as aggressively on behalf of target shareholders.[76]

More problematic, acquirers capture a larger fraction of the merger surplus in deals that involve a merger bonus or an unscheduled option grant.[77]

> [T]he financial cost to target shareholders of [merger side payments] would seem to exceed substantially the benefits received by their CEOs. This imbalance, arising from a conflict of interest between target CEOs and their shareholders, would seem to represent a wealth transfer from shareholders of the target to shareholders of the buyer.[78]

Similarly, "bidder returns involving a target that issues its CEO unscheduled stock options during private deal negotiations are about 2 percentage points higher."[79] Consistent with rent extraction, these results suggest a wealth transfer from target shareholders to both the target CEO and to acquiring shareholders.

The puzzle with rent extraction is to understand why a target's shareholders would vote to approve a merger that gives money away to the CEO. In the M&A context, side payments are disclosed to shareholders and the entire transaction is subject to both board *and* shareholder approval.[80] Informed shareholder approval generally mitigates concern related to conflicts of interest. Given these procedural safeguards, why do empirical studies of merger side payments nonetheless find evidence of rent extraction?

The existing literature does not have a good answer to this question. None of the finance studies discussed above explicitly

75. *See* Qiu, Trapkov & Yakoub, *supra* note 68, at 10–17 (discussing the possibility of selection bias due to the fact that only non-retained CEOs receive severance pay).

76. *Id.* at 26–27.

77. *See generally* Fich, *Option Grants*, *supra* note 35; Hartzell, *supra* note 24.

78. Hartzell, *supra* note 24, at 59.

79. Fich, *Option Grants*, *supra* note 35, at 415 (finding this result only applies to merger bonuses and unscheduled option grants). *But see* Eliezer M. Fich, Micah Officer & Anh L. Tran, Do Acquirers Benefit from Retaining Target CEOs? (June 13, 2014) (unpublished manuscript), http://22financeforum.unizar.es/wp-content/uploads/2014/11/22financeforum_submission_66_Do-acquirers-benefit-from-retaining-target-CEOs.pdf (finding that "acquirers do not appear to benefit, in terms of merger announcement returns or long-run operating performance from hiring the CEO of firms they acquire.").

80. *See* BAINBRIDGE, *supra* note 16, at 50.

consider the approval process necessary to enter into a merger.[81] Rather, they treat rent extraction via side payments as just another agency cost, perhaps caused by board capture.[82] This explanation, however, is better suited for the general discussion of managerial decision making, where shareholders are not entitled to a formal vote.[83] The next Part provides a new theory of rent extraction that does not depend on board capture and explains why shareholder voting, as currently exercised, cannot be relied on to prevent opportunistic side payments.

IV. NEW THEORY: BUNDLING SIDE PAYMENTS INTO MERGERS

Target CEOs can use a form of *agenda-setting* power to bundle an opportunistic side payment into a merger transaction that is desired by shareholders. By bundling the side payment into a single yes-or-no merger vote, management makes it impossible for target shareholders to oppose the side payment without also voting against the merger. Provided the bundled deal is better than the status quo (i.e. no merger), shareholders will rationally vote in favor of the entire transaction.[84] Thus, even if shareholders or directors would not have approved the side payment if structured as a pre-merger golden parachute, it is likely to receive shareholder support as part of a take-it-or-leave-it merger vote.

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81. *See* Fich, *Option Grants*, *supra* note 35; Hartzell, *supra* note 24; Heitzman, *supra* note 72; Qiu, Trapkov & Yakoub, *supra* note 68; Wulf, *supra* note 68.

82. There is a lack of theory work (i.e. formal models) specifically related to merger side payments. Empiricists are consequently drawing on theories developed in related contexts (e.g. executive compensation, golden parachutes, etc.) even though these settings differ from merger side payments in important ways. For example, studies often cite to LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004), for evidence of rent extraction in executive compensation.

83. While legal scholars generally pay much more attention to the process by which corporate decisions are authorized, they have almost completely overlooked the issue of merger side payments.

84. Glencore's efforts to acquire Xstrata illustrate this problem. *See* Steven Davidoff Solomon, *Gamesmanship in Xstrata-Glencore Merger Vote*, N.Y. TIMES (Oct. 25, 2012), http://dealbook.nytimes.com/2012/10/25/gamesmanship-in-xstrata-glencore-merger-vote/?_r=0. The initial deal proposal included approximately $275 million in retention bonuses to Xstrata management. *Id*. After deciding that Xstrata's CEO, Mick Davis, would no longer head the business post-merger, the proposed retention bonuses were reduced by $75 million, to an aggregate bonus of $200 million, but shareholders remained upset. *Id*. Xstrata added a shareholder-voting item on the retention bonuses, but it did not appear to give shareholders a meaningful ability to oppose the side payments without also blocking the entire deal. *See id*.

Originating in the political science literature,[85] bundling has received attention from corporate law scholars.[86] Bundling has been used to explain shareholder approval of dual-class recapitalizations in the late 1970s and early 1980s[87] and, more recently, shareholder approval of mergers where the surviving entity includes a staggered board provision in its charter.[88] The general claim is that management can bundle a provision that shareholders would normally oppose (e.g. a staggered board) with a "sweetener" that shareholders desire.[89] This Article extends the bundling insight to the analysis of merger side payments and provides a theory to explain evidence of rent extraction associated with such payouts.

The existing literature in corporate law focuses primarily on the vulnerability of shareholders to bundled transactions. As described by

85. *See* R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 219 (1990) (discussing bundling in the passage of a tax reform bill). *See generally* Michael D. Gilbert, *Single Subject Rules and the Legislative Process*, 67 U. PITT. L. REV. 803, 808–09 (2006) (finding that legislative compromises need to be bundled to improve political transparency); Kenneth A. Shepsle & Barry R. Weingast, *The Institutional Foundations of Committee Power*, 81 AM. POL. SCI. REV., Mar. 1987, at 85–104 (investigating why legislative committees are powerful and their role as agenda setters).

86. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 864–65 (2005) [hereinafter Bebchuk, *Shareholder Power*] (discussing the impact of bundling on reincorporation and charter amendment decisions); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1475 (1992) [hereinafter Bebchuk, *Federalism*] (examining the impact of bundling on approval of proposals for reincorporation); Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1839–40 (1989) [hereinafter Bebchuk, *Limiting Contractual Freedom*] (discussing shareholder decisions in voting on bundled amendments); Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1555–59 (2010) [hereinafter Bebchuk & Kamar] (summarizing the literature on bundling in corporate law); K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV. 1425 (generally addressing the bundling issue); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577–79 (1989) [hereinafter Gordon, *Structure of Corporate Law*] (examining bundling incentives); Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 143–49 (2010–2011) (discussing the impact that the federal "Say on Pay" rule has on bundling). *But see* Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1612 (1989) (reviewing Gordon, *Structure of Corporate Law*, *supra* note 86) (suggesting that bundling does not suggest coercion because shareholders will only approve of an outcome that is better than the status quo).

87. *See* Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1, 48 (1988) [hereinafter Gordon, *Ties that Bond*].

88. *See* Bebchuk & Kamar, *supra* note 86, at 1552–53 (examining the impact on bundling staggered board amendments with mergers to garner shareholder support).

89. *Id.*; Gordon, *Ties that Bond*, *supra* note 87, at 48.

Bebchuk and Kamar, "[o]nly the board is authorized under state corporate law to bring proposals for fundamental changes before shareholders for approval. Shareholders lack parallel authority to propose these changes and must vote on the board's proposals on an up-or-down basis."[90] The shareholder position is analogous to the inability of legislators to amend a bill coming out of committee under a *closed rule*, which is exactly the setting in which political scientists believe legislative riders are most problematic.[91] Provided the target's board is willing to endorse a side payment for its CEO, the shareholders are stuck: unable to amend the merger agreement and forced into a take-it-or-leave-it vote.

A. Bundling with an Independent Board

The above account of shareholder vulnerability implicitly treats the target board of directors as a rubber stamp for the deal negotiated by its CEO. There is certainly plenty of reason to believe that the board may be favorably inclined toward the CEO. Some of the directors may be corporate insiders working for the CEO, others may have been nominated by the CEO, or they may favor the CEO due to various forms of structural bias.[92] Furthermore, in the acquisition context, it is not uncommon for target directors to receive a side benefit themselves (e.g. a board seat with the acquirer)[93] in connection with the deal.

But what if this is not the case? What if the directors on target's board are truly independent of the CEO, and motivated to act in shareholder interests? Even with an independent board, there remains some risk of rent extraction through merger side payments. Targets generally rely on their CEO to negotiate the merger agreement.[94] This position gives the CEO considerable discretion to negotiate personal benefits into the agreement that is sent to the board.

90. Bebchuk & Kamar, *supra* note 86, at 1557 (footnotes omitted).

91. *See* Gilbert, *supra* note 85, at 842–43.

92. *See, e.g.*, Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 834 (2007) (describing structural bias as bias that arises because of "the cozy relationship [that] directors may have with officers . . . .").

93. *See generally* Mira Ganor, *Salvaged Directors or Perpetual Thrones?*, 5 VA. L. & BUS. REV. 267, 269 (2010).

94. *See* Heitzman, *supra* note 72, at 257 (finding evidence that the CEO had authority to negotiate on behalf of the target firm in more than half of the observations acquisitions).

To be sure, instead of letting the CEO negotiate the merger agreement, a board could appoint a special committee of independent directors or other outside parties to negotiate on behalf of target shareholders. Indeed, special negotiating committees are sometimes used.[95] Their primary use, however, appears to be limited to management buy-outs (MBOs) or other transactions involving roll-over equity plans for target managers.[96] In an MBO, the target management team is effectively the acquirer—often with support of a private equity firm—buying out the target's prior shareholders. Because of this conflict, in the context of an MBO, it does not make sense for target managers to negotiate on behalf of the target firm; thus the board forms a special negotiating committee.

The special committee will typically retain an investment to assist it and is also likely to conduct auctions to try to find an alternative acquirer.[97] In some auction deals, a special committee is used because management is one of the bidders for the target firm, even though the ultimate acquirer is unrelated to management.[98] Extending this logic, special committees could be used to deal with the conflict raised by side payments even when there is no prospect of an MBO. This use of the special committee, however, appears unusual. Using data from public acquisitions that includes a large number of private equity deals, Boone and Mulherin find that 24% of all acquisitions use a special committee; however, when MBOs and private equity deals are excluded, special committees remain infrequent.[99]

Why don't more boards appoint a special committee to negotiate their sales? One reason, of course, is that some boards may effectively be captured by their CEOs. But even for target boards acting in shareholder interest, there is plenty of reason to rely on the CEO as a primary negotiator. Boone and Mulherin, for example, suggest that special committees may be at a disadvantage in settings where insider

95. *See* Audra L. Boone & J. Harold Mulherin, *Who Monitors the Monitor? The Use of Special Committees by Target Firms in Corporate Takeovers,* J. CORP. FIN. 3 (forthcoming 2014), http://www.sciencedirect.com/science/article/pii/S0929119914000133.

96. *See id.* at 5.

97. *See id.* at 3.

98. *See id.* at 5.

99. *See id.* (showing that 58% of private equity deals and 42% of acquisitions by a private bidder (which includes MBOs) use a special negotiating committee, while acquisitions by a public acquirer only use a special negotiating committee in 9% (stock deals) to 20% (cash deals) of the observed deals).

knowledge is particularly valuable and can more easily be communicated by the CEO.[100] Also, the appointment of a special committee in settings that do not involve an MBO may be insulting to the target CEO and may undermine management's overall cooperation in the transition process, possibly destroying value.

Keeping the CEO invested in the process through the completion of the deal may be the best way to get a high price and preserve value for the target shareholders. One way to ensure the CEO's involvement is to let her negotiate the deal. Conversely, if the CEO leaves prior to closing or otherwise becomes uncooperative during negotiations, this could destroy a great deal of the firm's value to the acquirer. The CEO's holdup power makes it especially hard and costly for the board to replace her as primary negotiator on behalf of the firm. The CEO can use such holdup power to bargain for personal benefits.[101]

With respect to shareholders, the CEO's agenda-setting power is formal, in that shareholders cannot initiate fundamental transactions.[102] With respect to the board, the CEO's agenda-setting power is informal, based on the CEO's ability to hold up a transaction if her demands are not met. Unlike shareholders, a board can suggest amendments to a merger agreement, but it cannot, while acting in shareholders' interest, credibly threaten to scuttle a merger deal desired by shareholders simply to remove extra side payments. Rather, the board needs to believe that it would get a better deal for its shareholders by sending the CEO back to the bargaining table to ask for a higher price.

To illustrate the problem, consider the following example: the CEO of a target firm negotiates both (i) a merger agreement that includes a 30% premium for target shareholders, and (ii) a personal retention agreement which promises substantially higher pay—both equity and salary—than she received under her previous employment contract. Target's board may believe that its CEO is being offered a larger retention package than her marginal value to the acquiring firm and thus infer that the acquirer would have been willing to pay a

100. *See id.* at 6.

101. To be sure, holdup power does not imply that the target CEO has unilateral control over side payments. At a minimum, she must obtain the acquirer's consent to a side payment. However, the acquirer has an incentive to go along with such arrangements, provided it receives a corresponding reduction in the price that it must pay to the target shareholders. Empirical studies, as discussed above, find evidence that this tradeoff indeed occurs. *See supra* notes 68–78.

102. *See* Bebchuk & Kamar, *supra* note 86, at 1557.

higher merger premium to target shareholders if the CEO's retention agreement were scaled back to a reasonable level.

But since the target board has no voice in the negotiation of the retention agreement, how can it use this information? In theory, the target board could try to demand a higher share price and ask its CEO to give up some of her personal benefits if necessary to get the desired price. Such demand, however, may be perceived as interfering with the CEO's ability to negotiate future employment. Worse still, if a 30% premium is better than any alternative bidder is willing to offer, the board cannot credibly threaten to vote down the existing merger proposal.

The disagreement between the board and the CEO becomes a game of brinksmanship, except one where the benefit of holding out accrues primarily to the CEO, and the cost of a negotiation breakdown falls primarily on diffuse shareholders.[103] All parties—the target CEO, the board, and target shareholders—want the deal to go forward. The board's threat to block the deal because of the side payment is not credible, but neither is the CEO's threat to be uncooperative if she does not receive the rent extracting payment. Recognizing this dynamic, the board and the CEO can cooperate and split the merger surplus between them in some way. This has the effect of transferring shareholder surplus to the CEO.

In this setting, a shareholder-motivated board may simply acquiesce to the CEO's demands, especially recognizing that further merger negotiation is costly and could cause the proposed deal to fall apart. An independent board of directors may limit the extent of CEO rent extraction compared to a board captured by the CEO, but as long as the CEO remains the primary deal negotiator, even an independent

103. In governance conflicts where there are focused benefits and diffuse costs to an action, it is often argued that collective action problems will hinder the larger and less organized group and favor the smaller group. *See, e.g.*, MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965). The analogy does not extend perfectly to merger side payments, since the board can act as a representative of the diffuse shareholders. Nonetheless, there is a single CEO who captures 100% of the benefits from a merger side payment, negotiating against a board with multiple directors, none of whom personally capture 100% of the marginal benefit that they create for shareholders by aggressively challenging the CEO's side payment and obtaining a higher acquisition premium. In this setting, it is likely that an independent board of directors will acquiesce to some degree of rent extraction. For an analysis of collective action problems that shareholders face in bundled transactions, see Gordon, *Structure of Corporate Law*, *supra* note 86, at 1575–77; Gordon, *Ties that Bond*, *supra* note 87, at 42–47.

board cannot wholly prevent rent extraction. The CEO effectively presents a bundled deal both to the shareholders *and* to the board of directors. For the same reason that the shareholders are inclined to vote in favor of the transaction—it is better than the status quo—so too will the board.

This example emphasizes a second contribution this Article makes to the literature on bundling in corporate law. As I hope to show, the risk of rent extraction through merger side payments does not require a captured board of directors. The problem of bundling is orthogonal to standard debates about executive compensation[104] and debates in corporate governance regarding director primacy[105] versus shareholder empowerment.[106] Even if one believes that boards can generally do a good job setting CEO pay, one should be concerned about boards' ability to prevent rent extraction through merger side payments. Rent extraction may reflect the CEO's agenda-setting power in merger negotiations, rather than board capture.

104. The academic literature is split on whether boards are sufficiently independent from the CEO to engage in optimal contracting on behalf of shareholders or whether executive compensation terms are captured by managerial power. *See, e.g.*, Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1626–43 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004)); Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); BEBCHUK & FRIED, *supra* note 82; Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 683–87 (2005); Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACAD. MGMT. PERSP., May 2008, at 1, 5; Steven N. Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts and Challenges*, (Nat'l Bureau of Econ. Research, Working Paper No. 18395, Sept. 2012), http://www.nber.org/papers/w18395.pdf.

105. *See, e.g.*, Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 3 (2002); Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789 (2007).

106. *See, e.g.,* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Bebchuk, *Shareholder Power*, *supra* note 86; Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998); D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125 (2011).

B. Side Payments vs. Golden Parachutes

The focus on bundling also highlights an important, but overlooked, distinction between golden parachutes and merger side payments. Golden parachutes are not bundled into a specific merger transaction. Rather, parachutes are part of the CEO's employment contract and are negotiated at the time she is hired.[107] Ideally, a parachute should compensate the CEO for private benefits that may be lost if the firm is acquired and should align the CEO's interests with those of shareholders regarding a sale of the firm. This, of course, is basically the *incentive alignment* hypothesis for side payments.[108] To be sure, a captured board of directors may harm shareholders by awarding the CEO an excessive parachute payout, suggesting that *rent extraction* is also possible via golden parachutes.[109] A board controlled by the CEO increases the risk of CEO rent extraction through side payments, parachutes, and various other forms of executive compensation.[110] However, merger bundling only applies to side payments. Thus, to the extent that bundling is an independent cause of rent extraction, we should see higher levels of rent extraction through side payments as opposed to golden parachutes.

Though this prediction has not been tested, there are a number of studies showing that shareholders benefit from golden parachutes. First, some studies find that shareholders experience positive abnormal

107. Legally, a golden parachute is a provision in an executive's employment contract that entitles the executive to a payment in the event of a change-in-control (defined to include a sale) of the executive's firm. For a discussion of when golden parachutes should be negotiated, see Barbara Becker & Eduardo Gallardo, *Golden Parachute Compensation Practice Pointers*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Aug. 2, 2013), https://corpgov.law.harvard.edu/2013/08/02/golden-parachute-compensation-practice-pointers/. Golden parachutes may be periodically renegotiated based on changed circumstances.

108. *See supra* Section III.A.

109. Like side payments, golden parachutes are open to multiple interpretations. Because a golden parachute compensates the CEO for the loss of her job, she will support a sale at a lower price. On the one hand, this may benefit target shareholders by reducing the entrenchment motive and increasing the likelihood that a sale will occur. On the other hand, a golden parachute may lower the CEO's bargaining power relative to the acquirer. The acquirer knows the CEO has a golden parachute and it anticipates that she will accept a lower merger premium. Thus, the acquirer may be able to get a better price and capture a larger portion of the merger surplus when negotiating with a CEO protected by a golden parachute. *See, e.g.*, Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Golden Parachutes and the Wealth of Shareholders*, J. CORP. FIN., Apr. 2014, at 140, 140–41 (describing tradeoffs associated with golden parachutes).

110. *See* BEBCHUK & FRIED, *supra* note 82, at 80–81.

returns when golden parachutes are adopted.[111] Second, golden parachutes increase the likelihood that a firm will receive an acquisition offer and ultimately be acquired.[112] If we limit (i.e. condition) our analysis to firms that are actually acquired, we find that target firms that provide golden parachutes to the CEO receive smaller premiums; however, this *conditional* effect is more than offset by the increased likelihood of an acquisition.[113] Golden parachutes lead to higher unconditional expected acquisition premiums.[114]

To be sure, scholars express some concerns about golden parachutes. Most notably, golden parachutes may undermine managerial incentives for effort post-adoption. Concerns regarding managerial incentives also apply to merger side payments, at least to the extent that a side payment is anticipated. For example, in anticipation of receiving a side payment an executive may not mind having her firm acquired. The incentive problem, however, may be worse in the context of a golden parachute since the payment is contractually guaranteed. By contrast, a side payment is contingent and thus may be viewed as a reward for effort prior to the sale. Along these lines, Bebchuk, Cohen, and Wang find that firms "that adopt GPs experience negative abnormal stock returns both during and subsequent to the period surrounding their adoptions."[115] This suggests that golden parachutes may increase managerial slack.[116] They admit, however, that golden parachutes may be driven in part by selection bias, as firms adopting a golden parachute tend to be worse performing prior to the golden parachute.[117]

111. *See, e.g.*, Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making and Shareholder Wealth*, 7 J. ACCT. & ECON. 179, 183–89 (1985).

112. Bebchuk, Cohen & Wang, *supra* note 109, at 142–45, 153 (includes data on golden parachutes for all firms in the Investor Responsibility Research Center (IRRC) database from 1990 to 2006. This database includes corporate governance "provisions for 1,400 to 2,000 firms, including all the firms belonging to the S&P500 and other firms considered important by the IRRC," with longitudinal variation for each firm across IRRC volumes.).

113. *See id*. at 140–47.

114. *See id*. at 140–41, 147–48; *see also* Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, J. FIN. ECON., June 1995, at 3, 10–18 (explaining how to measure unconditional acquisition premiums).

115. Bebchuk, Cohen & Wang, *supra* note 109, at 140.

116. *See id*. at 153.

117. *See id*. at 151.

In addition to selection concerns, the study by Bebchuk, Cohen, and Wang also appears to suffer from omitted variable bias, as it fails to control for straight severance protection. Straight severance protection is a term in an executive's employment contract that entitles her to severance payments if she is terminated. It does not require a change-in-control event to trigger the payment. Firms that offer their CEO a golden parachute are more likely to also offer straight severance protection.[118] In a new article, Andrew Lund and Robert Schonlau re-estimate the regression models from Bebchuk, Cohen, and Wang, but add a control variable for severance.[119] Lund and Schonlau find that the negative effect on shareholder welfare (at least after 2006) is not driven by golden parachutes, but rather by the adoption of severance protection.[120] The fact that golden parachutes have no effect on a firm's performance once severance provisions are accounted for suggests that golden parachutes may have little impact on managerial slack. Overall, there appears to be more evidence that shareholders benefit from golden parachutes than from side payments.

Though golden parachutes may lower the threshold level at which a CEO is willing to support a sale of her firm, it does not create a conflict with respect to the CEO's negotiation of a merger premium. As long as the golden parachute is fixed in advance, the CEO still has every incentive to bargain for a high shareholder premium. By contrast, side payments create an incentive for the CEO to trade away shareholder premium in exchange for increased side payment.[121] Further empirical work is necessary to better assess the tradeoff between a golden parachute and a merger side payment. My analysis predicts a greater risk of rent extraction via merger side payments as compared to golden parachutes, and I hope that future empirical research tests this hypothesis.

118. *See* Andrew C.W. Lund & Robert Schonlau, *Golden Parachutes, Severance and Firm Value*, 16–20 (Oct. 28, 2015) (unpublished manuscript), http://ssrn.com/abstract=2682456 (noting a positive correlation between GPs and severance).

119. *See id.* at 28–29.

120. *Id.* at 4, 10–11.

121. The presence of a golden parachute does not appear to divert merger surplus away from target shareholders to the benefit of acquirers. *See* Eliezer M. Fich et al., *On the Importance of Golden Parachutes*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1717 (2013). Large golden parachutes are associated with higher acquirer returns, suggesting that excessive golden parachute contracts can undermine the CEO's bargaining power such that acquirers can get a lower price. *See id.* at 1746–47. But the general result is that target shareholders benefit from golden parachutes due to the increased likelihood of sale. *See id.* at 1748–51.

V. EXISTING LEGAL AND MARKET CONSTRAINTS

Given the above, it is, perhaps, surprising that public commentary has focused more on policing golden parachutes than on merger side payments. Nonetheless, several laws that regulate golden parachutes also apply to the use of merger side payments. In 1984, Congress attempted to discourage excessive parachutes and side payments by imposing tax penalties—sections 280G and 4999 of the Internal Revenue Code—on executive payouts above a threshold level.[122] More recently, the Dodd-Frank Act, which passed in 2010, requires publicly-held firms to allow advisory shareholder votes on change-of-control benefits, defined to include both golden parachutes and merger side payments.[123] These requirements are in addition to corporate law, securities regulation, and market forces which all work to constrain merger side payments in various ways. The remainder of this Part briefly describes existing legal and extra-legal protections for shareholders against merger side payments.

A. Multiple Bidders for Target

Probably the biggest constraint on opportunistic side payments comes from the prospect of a second bidder.[124] If side payments lead to a lower merger premium,[125] as predicted by rent extraction,[126] this creates an opportunity for a second bidder to enter the fray. In fact, the presence of side payments from the first bidder may give the second bidder an advantage in any resulting auction. The second bidder can devote its funds solely to shareholders and does not need to pay extra amounts to target executives. The second bidder can thus outbid the first bidder by up to the amount of excess side payments and still pay no more on a total basis.

122. *See* I.R.C. § 280G (2012); I.R.C. § 4999 (2012). For a discussion of these code provisions, see Joy Sabino Mullane, *The Unlearning Curve: Tax-Based Congressional Regulation of Executive Compensation*, 60 CATH. U. L. REV. 1045, 1050–56 (2011).

123. *See* Bebchuk, Cohen & Wang, *supra* note 109, at 140; *see also* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376, 1899–1900 (2010) (codified at 15 U.S.C. §78n–1 (2012)).

124. BAINBRIDGE, *supra* note 16, at 62.

125. This can arise because target managers are more willing to accept a lower share price when they receive side payments and because side payments eat up a portion of the total price that an acquirer is willing or able to pay.

126. *See supra* Section III.B.

The target CEO, the beneficiary of such side payments, may be reluctant to engage a competing bidder. The second bidder, however, can make its intentions known either by contacting the board with its offer or by making a tender offer directly to the firm's shareholders. Ultimately, such tactics place a great deal of pressure on the target CEO and the target board to remove excessive side payments and focus on shareholder interests. For one thing, this setting may trigger *Revlon* duties, placing additional legal obligations on the board to focus exclusively on shareholder interests.[127] Also, target shareholders will only accept a bundled transaction to the extent that it beats the deal offered by the next highest bidder. In essence, the arrival of a second bidder, or beliefs about latent bidders, transforms the status quo—or, more technically, the shareholders' threat position—from no deal at all to whatever the competing bidder is offering. In anticipation of such concerns the initial bidder may be reluctant to agree to large side payments; it does not want to make a low-ball offer that attracts competing bids.

If the market for corporate acquisitions were perfect (i.e. lots of bidders) and if all acquirers brought identical synergies to the table, the competition could eliminate rent extraction from merger side payments. Competition would force bidders to give the entire merger surplus to target shareholders. If a bidder tried to make a lower offer, an alternative acquirer would outbid it. With perfect competition, the acquirer would simply receive the market rate of return (i.e. no surplus) and the target CEO would receive the minimum side payment necessary for incentive alignment purposes.[128] Target shareholders would receive the entire merger surplus—an optimal result.

In reality, competition in the market for corporate acquisitions is imperfect at best. Most completed mergers involve a single bidder with some studies finding that over 90% of acquisitions involve only

127. When the sale or breakup of a firm is imminent, the firm's directors have fiduciary obligations—so-called *Revlon* duties—to get the best price possible for shareholders. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986); *see also* Stephen M. Bainbridge, *The Geography of* Revlon*-Land*, 81 FORDHAM L. REV. 3277 (2013).

128. The target CEO may also receive a retention contract or other benefits that increase the value of the target firm to the acquirer. The key point, however, is that with perfect competition, we would not need to worry about merger side payments as the market would force these to the level that maximizes the price the acquirer would pay to target shareholders.

one bidder.[129] Still, even if there is only one bidder, the target board must still take some steps to insure it is getting the best price for shareholders, as required by *Revlon*.[130] In practice, this means having an investment bank prepare a valuation analysis suggesting a fair price for the target and soliciting other bidders or running an auction to provide an off-market check of the acquisition price. With a well-designed sale process and no second bidder, it would be very difficult for an objecting shareholder to prevail on a *Revlon* claim.[131] In the absence of a second bidder, the target's board has considerable discretion to recommend a sale that includes a large side payment to the CEO and other senior executives.

Furthermore, in a strategic acquisition context, merger synergies likely depend on the identity of the buyer. Simply put, one buyer may be able to pay more than any other, not because of financing constraints but due to acquirer-specific synergies.[132] Such disparities suggest that more bidders may not be sufficient to remove rent extraction. If a less synergistic bidder were to emerge it would be unable to drive the price sufficiently high to squeeze out excessive side payments. Some degree of rent extraction remains. The result is a semi-competitive market for corporate control, one that limits but does not remove rent extraction.

B. Tax Incentives

The tax code—sections 280G and 4999—seeks to discourage excessive change-of-control payments to senior executives of target

129. *See* Sandra Betton, B. Espen Eckbo & Karin S. Thorburn, *Merger Negotiations and the Toehold Puzzle*, 91 J. FIN. ECON. 158, 164 tbl.1 (2009) (finding based on more than 10,000 acquisitions from 1973 to 2002 that the target firm received bids from multiple parties in only approximately 8% of the sample observations). Other studies find a higher degree of multi-bidder contests. *See, e.g.*, Nihat Aktas, Eric de Bodt & Richard Roll, *Negotiations Under the Threat of an Auction*, 98 J. FIN. ECON. 241, 243 (2010). Further, the lack of a second bidder does not rule out latent competition.

130. *Revlon, Inc.*, 506 A.2d at 182.

131. *Id.* at 182–84.

132. To illustrate, assume there are unique synergies between acquirer A and a hypothetical target firm. Acquirer A is willing to pay up to $150 million to buy target while other acquirers are only willing to pay up to $100 million for the target firm. Acquirer A could offer excessive side payments to the CEO of the target firm and still afford to pay $101 million for the target firm. Market pressure from other bidders, unfortunately, cannot drive down such side payments because the maximum amount that the other bidders are willing to pay for target is only $100 million.

firms.[133] A qualifying change-of-control payment is defined to include both merger side payments and golden parachutes.[134] These code provisions apply to both publicly-held and privately-held targets; however, privately-held targets can waive the requirement with a supermajority shareholder vote.[135] Provided that the aggregate amount of such payments (side payments plus golden parachute payments) is below a threshold level equal to three times the executive's average annual compensation over the past five years, these code provisions have no effect.[136] On the other hand, if a senior executive of the target firm receives side payments that exceed this threshold level, then she faces a 20% excise tax on all excess payments, in addition to the ordinary income taxes on such payments.[137] Also, the corporation may not take a tax deduction for the excess payments.[138]

These sections of the tax code suggest an alternative explanation for why empirical studies find a significant negative correlation between merger side payments and golden parachute entitlements.[139] The finance literature generally attributes this finding to incentive alignment, arguing that CEOs with inadequate severance protection (i.e. below average golden parachutes) require a larger side payment to align their incentives with those of shareholders.[140] An alternative view is that executives with low golden parachute entitlements have more cap-space under threshold payment level set by IRC section 280G, and thus can receive larger side payments without triggering a

133. I.R.C. §§ 280G(a), 4999 (2012).

134. The definition of a parachute payment in § 280G(b)(2)(A) is so sufficiently broad that it includes both golden parachutes and what I refer to as merger side payments.

135. The requirements of sections 280G and 4999 are waived for privately-held firms if (i) the firm has fewer than 100 shareholders and only one class of stock or (ii) a separate shareholder vote supported by at least 75% of the firm's shareholders is taken to authorize the side payment. *See* Susan Dixon & Jose Singer-Freeman, *Private Corporations and Section 280G of the Code*, PRACTICAL LAW CO. (2012), http://www.fdh.com/bulletin/0002.pdf.

136. See definition of "excess parachute payment" in I.R.C. § 280G(b)(1) (2012) ("[A]n amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.") and "base amount" in I.R.C. § 280G(b)(3) (2012) ("[T]he individual's annualized includible compensation for the base period.").

137. *See* I.R.C. § 4999(a) (2012).

138. *See* I.R.C. § 280G(a) (2012).

139. *See, e.g.*, Fich, *Contractual Revisions*, *supra* note 35; *see also* Hartzell, *supra* note 24.

140. *See, e.g.*, Fich, *Contractual Revisions*, *supra* note 35; *see also* Hartzell, *supra* note 24.

tax penalty.[141] Unfortunately, existing research has not clarified the impact that these tax provisions have on side payment levels.

It should be noted that sections 280G and 4999 in no way prohibit large side payments. Indeed, this is precisely the point of using a tax; the law taxes —rather than prohibits—excessive payouts to target executives in connection with a merger. The CEO of a target firm can negotiate for a merger side payment that exceeds three times her average base pay. Furthermore, a CEO may negotiate for a gross-up payment from the target corporation to cover any additional tax liability that he faces as a result of IRC section 4999. Indeed, having the corporation pay the CEO's tax liability does not appear to be an unusual outcome,[142] even though it leads to the incongruous result that shareholders ultimately pay the cost and are made worse off by a tax provision designed to protect shareholders from excessive change-of-control payments.[143]

C. Securities Regulation

Securities regulation protects shareholders through two primary mechanisms: (i) disclosure and (ii) a prohibition against fraud or deception. Consequently, in its proxy statement a target firm is obligated to disclose side payments, or related benefits, received by its CEO in connection with the acquisition.[144] Disclosure alerts shareholders to possible conflicts with the CEO, but disclosure does not give shareholders any meaningful ability to oppose an excessive side payment. In fact, even with full disclosure it may be perfectly rational for shareholders to vote in favor of a bundled merger transaction, regardless if it results in rent extraction. Jeff Gordon notes the inadequacy of disclosures as a remedy against bundling in the context of dual-class recapitalizations.[145] Many of the dual-class

141. Because the definition of a parachute payment in I.R.C. § 280G(b)(2)(A) (2012) includes both golden parachutes and side payments, the use of golden parachutes creates a deterrent for also granting side payments.

142. *See* Mullane, *supra* note 122, at 1054.

143. *See id*.

144. In its DEF14A filing, a target firm is obligated to disclose any economic interests that its directors and executive officers have in the merger that is different from, or in addition to, their interests as stockholders. *See* Information Required in Proxy Statement, 17 C.F.R. § 240.14a-101 (2016).

145. *See* Gordon, *Ties that Bond*, *supra* note 87, at 42–43. For a broader discussion of the limitations of disclosure, see Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure* (Pub. Law

recapitalizations studied by Gordon included an increase in annual dividend payments (desired by shareholders) in connection with the use of a dual-class structure that weakened shareholder-voting rights (opposed by shareholders).[146] Disclosure of the loss of voting rights associated with the dual-class structure did not prevent shareholders from approving these recapitalizations.[147] Full disclosure of side payments insulates the target firm against securities fraud, but disclosure by itself does not provide shareholders with any meaningful ability to voice their opposition to such arrangements, other than to vote against the entire merger.[148]

In addition to disclosure, securities regulation also addresses side payments and golden parachutes through advisory shareholder voting requirements under the 2010 Dodd-Frank Act.[149] The law gives shareholders an annual advisory (i.e., non-binding) vote on executive compensation generally (say-on-pay), and a separate advisory vote on golden parachutes (say-on-parachutes).[150] The say-on-parachute provision gives shareholders an opportunity to cast an advisory vote on some forms of merger side payments such as merger bonuses, unscheduled option grants, and augmented parachutes.[151] However, it does not cover retention agreements or board seats offered by the acquiring firm.

I am unaware of empirical studies examining the effectiveness of the SEC's new voting requirements as related to side payments. There has, however, been empirical work examining say-on-pay in Britain. Even though such vote is purely advisory, the British experience with say-on-pay suggests that it may limit excessive side payments, particularly if the payment could be characterized as a "reward for

& Legal Theory Working Paper Series, Paper No. 205, 2012), http://ssrn.com/abstract=2168427.

146. *See* Gordon, *Ties that Bond*, *supra* note 87, at 42–43.

147. *See id*.

148. *See* 17 C.F.R. § 240.14a-101 (2016).

149. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1375, 1899 (2010) (adding new section 14A to the Securities Exchange Act of 1934).

150. *See id*.

151. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291 § 14A(b)(2), 48 Stat. 881, 895–96 (codified at Shareholder Approval Of Executive Compensation, 15 U.S.C. § 78n-1 (2012)).

failure."[152] Furthermore, an advisory vote on merger side payments may have desirable ancillary effects on other areas of corporate law and securities regulation, most importantly by forcing the target board of directors to make an explicit voting recommendation regarding the CEO's side payment.

In order to recommend that shareholders vote *for* a particular side payment, a voting item on the proxy statement, the board may need to state its reasons for such advice.[153] Such disclosure is not costly in itself, but it would force a board to come up with reasons justifying the side payment. Furthermore, the board would need to *believe* that such reasons are in fact true. If a board does not believe its own advice, it may be open to liability under SEC Rule 14a-9 for a deceptive opinion.[154] In the context of side payments, this means that a target's board would need to convince itself that the requested side payments were in fact necessary for incentive alignment purposes. To support its voting advice on the say-on-side payment issue, the board is likely to monitor side payments more closely, possibly even seeking a fairness opinion related to certain side payments. Thus, while it is too early to tell if the say-on-side payment votes, which have only been in effect for the past couple of years, will constrain rent extraction, there is at least some reason for optimism.

On the other hand, the analogy to say-on-pay may break down if an acquisition is an end-of-life event for the target firm, reducing the shame of receiving a negative shareholder vote. A target CEO, who does not have to return to work the next day, may be less susceptible to shaming and other informal sanctions, at least compared to a typical say-on-pay vote. While disclosure and advisory voting may limit rent extraction, this does not solve the inherent problem presented by bundling.

D. Corporate Law

Under corporate law, shareholders may seek an injunction or damages if a merger side payment were to create sufficient conflicts to

152. *See* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. FIN. 527, 528 (2013).

153. *See* 17 C.F.R. § 240.14a-101 (2016).

154. *See* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1091–96 (1991). In addition to showing that the directors did not believe their own opinions, a plaintiff would also need to show that such opinions were in fact wrong. *Id.*

contaminate a board's merger recommendation. As a practical matter, however, such conflicts will generally be cleansed through the merger approval process, meaning the entire transaction—including the side payment—would typically be protected by the business judgment rule.[155]

It is hard to imagine a realistic fact pattern where side payments would be a sufficient problem for a judge to award an injunction. Even if a conflict were truly extreme, such that it could not be adequately cleansed or merger negotiations were conducted in bad faith, a judge may be reluctant to issue an injunction. The judge would be presented with the same bundled offer that shareholders and directors have an incentive to support because it is better than the status quo.

Shareholder litigation related to the 2012 acquisition of El Paso Corporation by Kinder Morgan illustrates the limitation of the injunctive remedy. This deal included substantial side benefits to El Paso's CEO, Douglas Foshee.[156] Based on this and other conflicts, a group of El Paso shareholders sued for an injunction.[157] The Delaware Chancery Court judge hearing the case, Leo Strine, admitted that conflicts of interest impacted the negotiation of the El Paso buyout.[158] "[W]hen El Paso's CEO was supposed to be getting the maximum price from Kinder Morgan, he actually had an interest in not doing that."[159] Despite these facts, Chancellor Strine "reluctantly" denied the shareholders' motion because of the high-proposed buyout premium.[160]

> The record thus persuades me that the plaintiffs have a reasonable likelihood of success in proving that the Merger was tainted by disloyalty. Because, however, there is no other bid on the table and the stockholders of El Paso, as the seller, have a choice whether to turn down the Merger themselves, the balance of harms counsels

155. *See, e.g.*, BAINBRIDGE, *supra* note 16, at 56–62 (discussing the legal treatment of side payments).

156. Scott Thurm, *El Paso CEO Is Set for $91 Million in Exit Pay After Kinder Morgan Deal*, WALL ST. J. (Oct. 18, 2011), http://www.wsj.com/articles/SB10001424052970204346104576637433532101762.

157. *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 432 (Del. Ch. 2012).

158. *See id.* at 434.

159. *Id.*

160. *Id.* at 452; *see also* Michael J. de la Merced & Clifford Krauss, *Kinder Morgan to Buy El Paso for $21.1 Billion*, N.Y. TIMES (Oct. 16, 2011, 9:53 PM), http://dealbook.nytimes.com/2011/10/16/kinder-morgan-to-buy-el-paso/?_r=0 (noting that the deal included a 37% acquisition premium).

> against a preliminary injunction. Although the pursuit of a monetary damages award may not be likely to promise full relief, the record does not instill in me the confidence to deny, by grant of an injunction, El Paso's stockholders from accepting a transaction that they may find desirable in current market conditions, despite the disturbing behavior that led to the final terms.[161]

Judges do not have a line-item veto, and are therefore reluctant to strike down a multi-billion-dollar transaction because of side payments. Judges are reluctant to use their injunctive power for the same reason that shareholders and directors have trouble blocking such deals—a deal with an unsavory side payment is better than no deal at all.

A fiduciary suit for monetary damages offers more promise. In a fiduciary suit, a judge would not have to block the entire transaction. In theory, with full information a judge could separate the rent extraction component from the incentive alignment component, and appropriately set damages so as to not discourage mergers which may require a side payment, but to set damages that penalize rent extraction.

This view of monetary damages is problematic for several reasons. First, it may be unrealistic to assume that a court can accurately separate rent assignment from incentive alignment in setting damages. If courts frequently make errors and overstate damages, this could inadvertently discourage valuable deals from going forward. Target's CEO may be concerned that an incentive alignment side payment will nonetheless be challenged in court and, fearing a non-trivial chance of judicial error, the CEO may decide instead to block the sale altogether.

Even if we assume that courts can accurately set damages to encourage incentive alignment and discourage rent extraction, there is still the problem that under current law most fiduciary suits based on a merger side payment will never even get to the damages stage of the litigation. First, plaintiff has to successfully argue that the case is direct rather than derivative, as target shareholders have no standing to bring a derivate suit after a deal has been completed.[162]

161. *In re El Paso Corp.*, 41 A.3d at 434–35.

162. After a merger is completed, the derivative standing of former shareholders of the target firm is generally extinguished. *See generally* Lewis v. Anderson, 477 A.2d 1040 (Del. 1984).

Second, the plaintiff must successfully characterize the side payments and other benefits received by target executives as a conflict of interest for fiduciary purposes. After the foregoing discussion this may seem obvious, but it is not. Indeed, courts do not generally treat an executive's retention agreement or acceptance of a board seat with the acquiring firm as a conflict of interest.[163] Consequently, a board's recommendation of a sale involving such benefits will not receive judicial scrutiny absent other facts.

Finally, supposing a plaintiff is able to show a conflict of interest, that conflict will generally be cleansed through the merger approval process. Under Delaware General Corporation Law (DGCL) section 144, a conflict of interest can be procedurally cleansed if all material facts related to the conflict of interest are disclosed, or known, and the transaction is then authorized by either (i) the affirmative votes of a majority of the disinterested directors acting in good faith,[164] or (ii) a majority of shareholder voting in good faith.[165] The result of such cleansing is that the transaction will generally be given protection under the business judgment rule, effectively shielding the action from judicial review and leading to dismissal.

When DGCL 144 is applied to a conflict created by a merger side payment, this means that the entire transaction—including the side payment—is cleansed by an informed vote supported by a majority of the firm's independent directors or by an informed shareholder vote. In the context of a merger, a vote will necessarily occur at both the board level and at the shareholder level, meaning the conflict associated with the side payment is effectively cleansed through disclosure and support for the merger.[166]

To be sure, the Delaware Supreme Court in a recent decision, *Gantler v. Stephens*, suggests a narrower interpretation of stockholder

163. *See, e.g.*, *In re* W. Nat'l Corp. S'holders Litig., No. 15927, 2000 WL 710192 (Del. Ch. May 22, 2000) (holding that cash payments to target executives neither create a conflict of interest nor breach of duty of loyalty); *In re* Smurfit-Stone Container Corp. S'holder Litig., No. 6164-VCP, 2011 WL 2028076 (Del. Ch. May 20, 2011) (expectation of employment with the new company is not, in itself, sufficient to establish a conflict of interest on the part of the directors).

164. DEL. CODE ANN. tit. 8, § 144(a)(1) (2016).

165. DEL. CODE ANN. tit. 8, § 144(a)(2) (2016). Alternatively, a self-dealing transaction can be cleansed by showing that the transaction is entirely fair to shareholders. *See* DEL. CODE ANN. tit. 8, § 144(a)(3) (2016).

166. *See* BAINBRIDGE, *supra* note 16, at 50.

ratification.[167] Specifically, "the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve."[168] Applied to the context of merger side payments, this suggests that a bundled shareholder vote approving a merger transaction would not be sufficient to cleanse side payments to the firm's CEO.

Nonetheless, practitioners have found a work-around to this problem by providing a separate shareholder vote for the issue to be cleansed, and making the broader deal contingent on an affirmative shareholder vote on the cleansing issue.[169] In the context of merger side payments, this workaround effectively re-bundles the side payment into the broader merger vote. A shareholder who wishes to vote in favor of the merger must also vote for the issue to be cleansed. Nonetheless, even if the target firm does not provide a separate shareholder voting item for merger side payments as suggested by *Gantler*, the side payment would be entitled to business judgment protection by the vote of a majority of disinterested directors.[170] Under current law, absent bad-faith negotiation tactics,[171] a merger side payment is likely to be shielded from judicial review and such a case is likely to be quickly dismissed.[172]

VI. ANALYSIS AND LAW REFORM

In this Part, I first consider the desirability of existing laws regulating merger side payments. I then propose two legal reforms that may reduce the risk of rent extraction through side payments without blocking them altogether. In particular, I consider (i) upfront contractual restrictions limiting side payments, and (ii) an amendment to corporate law.

167. *See* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

168. *Id*. at 713.

169. *See* Mark J. Gentile, John Mark Zeberkiewicz & Megan R. Wischmeier, *Stockholder Ratification: A Review of the Benefits and Burdens*, BLOOMBERG L. REP., Feb. 2009, at 2.

170. DEL. CODE ANN. tit. 8, § 144(a)(1) (2016).

171. *See* Parnes v. Bally Entm't Corp., 722 A.2d 1243 (Del. 1999) (showing that bad-faith negotiation by the CEO regarding side payments removes business judgment rule protection).

172. This assumes that the case will even be classified as a direct suit that does not need to plead demand futility. In a post-merger fiduciary challenge, a former shareholder generally lacks standing to bring a derivative suit.

A. Current Law as Second Best

Even acknowledging that the law fails to prevent rent extraction, one may still view the current set of legal protections as the best available for an imperfect world. This view is especially attractive in light of longstanding legal acceptance of takeover defenses such as the poison pill.[173] Hostile takeovers have largely disappeared since the end of the 1980s.[174] In this environment, merger side payments are one of the few tools that can be used to overcome managerial entrenchment. The law responds by allowing side payments, but adding disclosure and a tax penalty for especially large side payments. This has the benefit of facilitating a sale of the firm, while putting soft protections in place that prevent extreme forms of rent extraction.

In further support of the current legal regime, rent extraction is only a distributional problem. Rent extraction does not prevent the ex post efficient outcome (sale of the firm) and it does not diminish the size of the merger surplus. It merely redistributes benefits from shareholders to the CEO, but the total size of the gains remains the same. This point is easily seen in Table 2 by comparing the $3 million side payment to the $13 million side payment.[175] In both cases, the same merger surplus ($97 million) is created.[176] From an ex post efficiency perspective, it does not matter whether these gains go to shareholders or to the CEO.

Focusing exclusively on the sale, however, hides various ex ante distortions that may arise in expectation of rent extraction. First, expectation of a large side payment may undermine a manager's incentive to put forth effort throughout her employment period. More generally, side payments undermine the disciplinary effect of the market for corporate control. In the corporate governance literature, the threat of losing one's job through a takeover serves as an important disciplining device for top executives.[177] Under the standard

173. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (validating the use of a poison pill defensive measure).

174. *See* Andrade, Mitchell & Stafford, *supra* note 18, at 106 (finding that only 4% of acquisitions between 1990 and 1998 involved a hostile bid at any point in the deal process).

175. *See supra* Table 2.

176. *See supra* Table 2.

177. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (introducing the concept of a market for corporate control and discussing the disciplinary impact of corporate managers); Michael C. Jensen, *Takeovers: Their*

view, a manager realizes that if her firm underperforms it will become an attractive takeover target for an acquirer hoping to turn the business around, and in the process she will lose her job as "punishment" for poor performance.[178] Yet, the punishment loses its bite if the CEO is able to extract a large side payment on the way out the door. Anticipating this, a CEO may be indifferent to the threat of takeover and invest less effort into her job ex ante. In this context, side payments create a reward for failure.

Second, worse than merely being indifferent, a CEO may actually seek out a merger side payment. This may cause a manager to waste effort endogenously positioning her firm to be acquired. At the extreme, this may even cause the firm to inefficiently change its underlying projects to better situate itself for an acquisition. Even though shareholders receive a merger premium from any resulting sale, management may have caused the firm to forego some positive net present value (NPV) projects in the pursuit of being acquired.

Third, expectation of rent extraction may raise the upfront cost of capital. Equity investors anticipate that managers may extract value through a side payment and they price the shares accordingly. With a higher cost of capital some desirable projects (positive NPV) may fail to attract financing and economic growth may be compromised. To be sure, for publicly-held targets, merger side payments are modest compared to the acquisition price, and target shareholders still capture most of the gains from sale.[179] If this were the only problem, the effect on the cost of capital would be modest. However, if we also consider that equity investors may anticipate the distorting effect that large side payments may have on managerial effort during the course of employment and price this into their upfront investment, then the effect on cost of capital potentially becomes much worse. Namely, potential investors will demand higher upfront returns (i.e. more equity) to compensate for value they might lose to side payments ex

Causes and Consequences, 2 J. ECON. PERSP. 21 (1988) (noting that threat of takeover can help align executives' incentives with shareholders).

178. Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671, 671 (1991).

179. For an angel investor or other party financing a privately-held firm, the concern over rent extraction may be more severe, as side payments are much larger as a fraction of deal size. *See* Broughman & Fried, *Carrots and Sticks, supra* note 25, at 1351 (noting, that when offered, non-retention management bonuses to executives of VC-backed firms are on average 6.6% of the merger price).

post. Unfortunately, we cannot measure the magnitude of such ex ante distortions, but these concerns at least cast doubt on the optimality of current legal protections.

B. Possible Reforms

Merger side payments present a particularly difficult challenge for law reform. Usual corporate governance mechanisms such as disclosure and director independence are inadequate.[180] The problem is further complicated by the fact that side payments are sometimes necessary to counter managerial entrenchment. Any *reform* that blocks side payments runs the risk that it may prevent transactions desired by shareholders. Managerial entrenchment is potentially a much worse problem than rent extraction.[181]

In Section VI.B, I consider two possible reforms that may reduce the use of side payments as rent extraction without blocking them altogether. First, I evaluate contractual restrictions on side payments, noting two limitations of this approach: (i) waiver through bundled renegotiation and (ii) inability to specify the incentive alignment payment ex ante. Second, I propose a small amendment to corporate law. Firms should be given the choice to opt into a heightened fiduciary standard by placing language in their charters requiring that any side benefit received by the CEO can only be cleansed via a separate vote upon which the broader acquisition cannot be contingent.

1. Contract

The relationship between a firm and its CEO is part of the broader nexus of contractual relations that define an organization.[182] Consequently one might hope that a contractual provision could be designed to limit rent extraction through merger side payments. For example, when negotiating over a CEO's employment contract the

180. *See supra* Sections V.C & V.D.

181. Furthermore, some side payments—such as retention agreements, non-competes, and post-merger consulting—may be desired by acquirers, and may increase the size of the merger surplus. An acquirer may be willing to pay more for the target firm if it is able to retain key employees, and design appropriate contracts to incentivize such individuals going forward. Consequently, any reform proposal that interferes with an acquirer's ability to offer a retention agreement to target executives would probably lead to worse problems than the risk of rent extraction under the current law.

182. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989) (describing corporate entities as a nexus of contractual relations).

firm could ask for a provision limiting the dollar amount that the CEO can receive through any form of merger side payment to some capped amount. This can be thought of as an iron weight attached to the CEO's golden parachute.

To illustrate with a concrete example, the CEO may bargain for a golden parachute that *entitles* her to a payment equal to $1.5M if the firm is acquired, and the employer may ask for an iron weight that *limits* the total amount of "merger benefits"—including both golden parachutes and side payments—that the CEO can receive from any future acquisition to $2M. This would effectively give the CEO freedom to negotiate up to $0.5M in side payments in addition to her contractual entitlement to a $1.5M parachute. "Merger benefits" would need to be defined broadly in the merger agreement so that it includes all forms of side payments including excess compensation (above a defined amount) received through a retention contract or post-merger consulting from the acquirer, and a remedy would need to be specified (e.g. clawback) if the CEO were to receive excess payments.

Putting aside definitional concerns and questions about the enforceability of a restriction on compensation from an acquiring firm as future employer,[183] there is an appeal to the iron-weight contract clause. Whereas a golden parachute entitles the CEO to a defined payment upon a change-in-control, an iron weight would set a limitation on the amount that a CEO could extract through extra side payments. By setting the iron-weight cap at the right level this provision may limit rent extraction without blocking incentive alignment.

There are, however, two serious limitations that apply to any contractual solution. The first concern is that, under existing law, contracting parties cannot prevent consensual renegotiation of their original contract.[184] This is an oft-noted problem in the literature on

183. The acquirer is not a party to the contract provision and the iron weight restriction may be viewed as type of a non-compete that places unreasonable constraints on future employment. *See, e.g.*, Cynthia L. Estlund, *Between Rights and Contract: Arbitration Agreements and Non-Compete Covenants as a Hybrid Form of Employment Law*, 155 U. PA. L. REV. 379, 391–92 (2006) (discussing limited enforceability of non-compete agreement).

184. This is an oft-noted problem in the literature on contract theory. *See, e.g.*, Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 204 (1997) (suggesting potential benefits from a commitment to not renegotiate).

contract theory, and is especially problematic in the context of merger side payments.[185] To illustrate, a CEO could negotiate a desirable M&A sale where waiver of the iron weight is a condition to closing the sale. The CEO could then negotiate for a large side payment (in excess of the iron-weight cap) and bundle all of this together into one deal. Technically, the board would need to consent separately to a waiver of the iron-weight provision. But the arrangement would be bundled such that the board cannot authorize the merger agreement without first waiving the iron weight.[186] The CEO's agenda-setting power is used here to remove an inconvenient (to her) contractual restriction.

For the same reason that side payments can be bundled into a merger agreement, a waiver or amendment of *any* contract provision can be bundled into a merger. The CEO has agenda-setting power to construct a bundled deal, which the board and shareholders are forced to accept or reject through a take-it-or-leave-it vote. The parties may try to address this problem up front by requiring a supermajority vote for any amendment to the iron weight provision, but even this is inadequate because it is *rational* for all directors and all shareholders to waive the iron weight when it is bundled into a desirable sale of the firm.[187]

A second concern with any contractual solution is that the parties may be unable to specify with any precision the incentive alignment payment ex ante. This amount may depend on non-verifiable future contingencies that cannot be contracted over ex ante. Given an incomplete contract setup the parties may be reluctant to specify an iron weight that could inadvertently block a desirable merger by setting the incentive alignment compensation too low. In this case it may be a good thing that the parties can renegotiate ex ante provisions. But it also suggests that an ex ante iron-weight contract may be a pointless exercise that at best merely increases transactions costs, and at worst may prevent a valuable sale from occurring.

185. *See id.*

186. *See supra* Part IV.

187. For example, the parties may consider trying to add this provision to the corporate charter, such that it requires shareholder consent—possibly at a supermajority level—to modify the iron-weight provision.

2. Corporate law reform

Given the inability of a contract to prevent rent extraction, I propose a small amendment to corporate law. Firms should be given the choice to opt into a heightened fiduciary standard by placing language in their charter requiring that any side benefit received by the CEO—and possibly other members of senior management—can only be cleansed via a separate vote, upon which the broader acquisition cannot be contingent.

The problem with the existing law is it treats authorization of a merger as authorization of each component of the deal (merger and side payment).[188] Yet, shareholders and directors only vote on the combined bundle rather than on each part separately. Shareholder approval of a bundled vote does not mean that each element of the deal is good for shareholders. It merely means that the entire transaction is better than no deal at all. The shareholders may still disfavor the side payment component.

One way to implement an *opt-in* reform would be to limit DGCL sections 144(a)(1) and (a)(2)—provisions describing the cleansing of conflict-of-interest transactions—to director or shareholder votes that were in some meaningful sense unbundled from the broader merger authorization. At a minimum, this would require a separate board or shareholder vote authorizing the side payment. Such vote must not be tied to the passage of a specific merger transaction. For example, if the merger agreement made acceptance of the side payment a condition to closing, the side payment obviously would not be unbundled, even if shareholders were given a chance to vote on the side payment separate from the broader merger vote. Informed shareholders would understand that they need to vote *yes* on the side payment if they want the merger to go forward; the mere presence of a separate voting item would be irrelevant.

Board or shareholder authorization of a side payment could either occur: (i) prior to the vote on a specific M&A transaction (pre-deal vote); or (ii) at the same time as the M&A vote (concurrent vote). A side payment authorized by a pre-deal vote is functionally a golden parachute, since the payout would be set prior to the terms of a merger agreement. If a pre-deal vote occurs in close proximity to a specific merger transaction, one may worry that this arrangement reflects an informal or implicit form of bundling. Shareholders may correctly

188. *See supra* notes 163–69 and accompanying text.

understand that if they vote against a pre-deal side payment they are effectively rejecting a potential merger proposal.

As long as the acquisition terms have not yet been set, however, this is not actually bundling, but rather reflects the reality that management has a credible threat to block a sale of the firm. To see the distinction, note that if the shareholders vote in favor of a pre-deal side payment, the amount of side payment is now fixed. Management can subsequently bargain with an acquirer over the sale of the firm, but management cannot trade off merger premium for a larger side payment, since the side payment is fixed in advance. Put another way, authorization by a pre-deal vote may be necessary to get management to the negotiation table, but once they are at the table their bargaining incentives are aligned with shareholder welfare.

By contrast, a side payment authorized by a concurrent vote may be problematic for the opposite reason. Here the merger and the side payment are separate voting items on the same proxy card (i.e. corporate ballot).[189] Management puts the merger up for vote without knowing if they will receive the side payment, and for cleansing purposes, the merger itself cannot be made contingent on whether the side payment received shareholder support.[190] If the side payment is necessary for incentive alignment purposes the CEO may be very reluctant to go this route. To avoid the possibility that shareholders may decline to approve an ex post side payment, firms would be encouraged to address the problem ex ante by adopting a golden parachute (i.e. a pre-deal side payment).

My proposal does not attempt to block side payments; rather, it switches the level of judicial scrutiny based on how the side payment is authorized. If a side payment is authorized by an informed shareholder vote or by a vote of the independent directors, and such vote is decoupled from the merger itself, then (absent other problems) the transaction should be entitled to protection under the business judgment rule. By contrast, if a side payment is important for incentive alignment purposes and the deal planners do not want to expose it to shareholder or independent director vote, then they can still go forward with the sale and include the side payment, but the

189. The vote here would be concurrent, since the two items would be voted on at the same time.

190. After numerous shareholder complaints, this form of voting appears to have been the outcome in the XTRATA acquisition. *See* Steven Davidoff Solomon, *Gamesmanship in Xstrata-Glencore Merger Vote*, N.Y. TIMES (Oct. 25, 2012, 3:54 PM), http://dealbook.nytimes.com/2012/10/25/gamesmanship-in-xstrata-glencore-merger-vote/?_r=0.

transaction is no longer entitled to business judgment rule protection. Rather, the transaction would be scrutinized under the entire fairness standard, meaning that courts would inquire into whether the side payment was desirable for shareholders of the target firm. This approach is only a small departure from the existing law.

Indeed, I have intentionally made this a fairly modest proposal out of concern that any more aggressive constraints on side payments may inadvertently increase managerial entrenchment. For this reason, I also suggest that this reform should be one that firms choose whether to opt-into or not. There is no reason that this needs to be a mandatory requirement. Instead, shareholders can decide whether they value extra protection against side payments, or whether they prefer the status quo. I believe my proposal could reduce the CEO's agenda-setting power with respect to side payments, while still giving firms flexibility to compensate the CEO for negotiating a sale of the business.

VII. Conclusion

In this Article, I propose a new theory for merger side payments that helps explain evidence of rent extraction through side payments. While a typical agency conflict is driven by shareholders' inability to observe bad behavior and lack of incentive to invest effort-monitoring management, merger side payments present a different problem. Similar to a legislative rider attached to a popular bill, target CEOs can use control over the corporate agenda to bundle an opportunistic side payment into a desired merger transaction, thereby making it impossible for target shareholders to oppose the side payment without also voting against the merger. Because side payments are bundled into a merger transaction, disclosure and voting rights cannot adequately protect shareholders against rent extraction. Instead, I propose a small reform to corporate law to help unbundle side payments from the broader merger vote, forcing the CEO to give up some of her agenda-setting power with respect to the design of side payments.

This project contributes to literature on bundling in corporate law. My theory suggests testable predictions for comparing rent extraction through golden parachutes and merger side payments. I hope that future researchers will test these predictions, and that my analysis will be useful to judges and other policy makers addressing merger side payments.