The CEO-Advisors Nexus: Toward an Explanation of 'Merger Preference' in Mergers and Acquisitions

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Abstract

In this theoretical paper we are investigating the important question of why, in the face of strong evidence that mergers and acquisitions (M&As) do not generate returns for acquiring company shareholders, CEOs continue to pursue these strategies. Drawing on a variety of theoretical perspectives, we argue that the firm's agents (the CEO and executives) and M&A promoters (investment bankers, lawyers and other advisors) have developed non-efficiency based relationships in the context of increased competitive pressures and a crisis in corporate ethics. The key theoretical point is that the nexus between CEOs, professional advisors and boards provides a more compelling explanation for the observed merger preference phenomenon than either the agency problem or the promoter effect on their own. Implications of the model for practice, research and theory building are discussed.

Key words: Mergers and acquisitions, value appropriation, agency theory, advisors.

Introduction

One of the most pervasive features of today's corporate landscape is worldwide industry restructuring through domestic and cross-border mergers and acquisitions (M&As). A major characteristic of this most recent M&A wave has been the growing magnitude of deals with values in excess of $1 billion (UNCTAD, 2000). The developed economies have witnessed several M&A waves throughout the 20th century (see DuBoff and Herman, 1989; Chandler, 1990; Stearns and Allan, 1996); and while each of these waves was driven by a unique set of circumstances and resulted in different outcomes, the most unequivocal empirical finding has been that the shareholders of the acquiring firms did not benefit from these M&A strategies (see, for example, Tichy, 2001, for a recent review of event and outcome studies).

In this theoretical paper we are investigating the important question of why, in the face of such strong evidence that M&As destroy economic value for their shareholders, senior executives continue to pursue M&As, and on an ever-larger scale. Following DuBoff and Herman (1989, p. 126), we refer to this managerial pursuit of M&A strategies as 'merger preference'. Scholars (e.g., Roll, 1988; Shleifer and Vishny, 1991; Markides and Oyon, 1998; Seth, Song and Pettit, 2002) have addressed this 'merger preference' paradox by investigating managerial motives driving M&As through uni- or multi-theoretic lenses. In addition to synergies – the often quoted yet rarely realized motive for M&As (Sirower, 1997) – managers tend to engage in acquisitions for reasons unrelated to economic value creation. The managerial discretion theory (Marris, 1964) predicts that managers will embark on acquisitions to maximize their own utility, often via benefits associated with increased firm size, rather than shareholder value. Other theoretical perspectives focus on the cognitive impairments of the decision-making process. The hubris hypothesis (Hayward and Hambrick, 1997; Roll, 1988) suggests that managers make mistakes in evaluating target firms and, at the extreme, predicts that the entire value created through synergies, industry consolidation and asset restructuring is transferred to the target-firm shareholders in the acquisition premium. Bruner (1999) argues for the escalation of senior management commitment as a complementing motive for M&As: once a decision is made, there are powerful psychological, environmental and structural pressures to persist with the failing course of action. Reinforcing Bruner's argument is the notion of M&As taking the form of a 'dollar auction' as a paradigm for escalation because of the economic and psychological sunk costs associated with the acquisition

process (Shubik, 2002): after two bidders join the contest, the winner will fall victim to what is commonly known in financial economics as 'the winner's curse' (paying a high acquisition premium), while the loser will face psychological and economic costs of 'the underbidder's curse'. Although diverse, this literature explores the motivations of an individual manager, typically (but not solely) within the dyadic manager-shareholders relationship.

Scholars who focus on managerial motives in M&As and, therefore, on managers as the potential beneficiaries, tend to ignore other beneficiaries of corporate mergers. Nonetheless, these beneficiaries have been instrumental in promoting M&A transactions that do not enhance long-term profitability of acquiring firms (see Porter, 1987; DuBoff and Herman, 1989). One possible explanation of this lack of attention may be that scholars – particularly those belonging to the organizational economics school (e.g., Fama and Jensen, 1983; Williamson, 1985) – have often espoused the atomistic, non-relational view of organizations. Drawing liberally on a diverse set of theoretical perspectives, we will advance our own hypothesis as to why firms continue to aggressively pursue acquisitions by exploring the relationships within a nexus of actors who participate in M&A activity.

The main thesis in this paper is that the firm's agents (the CEO and executives) and M&A promoters (investment bankers, lawyers and other advisors) have developed non-efficiency based relationships in the context of increased competitive pressures and a crisis in corporate ethics. The nexus between the agents and promoters has the compounding effect of encouraging acquisitions that destroy economic value and inducing the 'merger preference'. As long as this nexus continues to exist, senior managers will continue to exhibit 'merger preference' and pursue M&A strategies geared to value appropriation by the members of the nexus at the expense of shareholders.

The paper opens with a discussion of the relationships between shareholders, boards, CEOs and advisors and their opportunities for value appropriation. We then develop propositions about how 'merger preference' is induced by the CEO agency problem and the advisors' promoter effect. In conclusion, we discuss the contributions, and implications for practice, research and theory building.

We note that in this paper we are explicitly interested in large, publicly-owned corporations which are not owner-managed. This focus sets the boundary assumption for our subsequent theoretical development.

The nexus between agents and promoters

Agents in the M&A environment

We begin our discussion with a simple observation that there are multiple actors with divergent and in some cases, as we will argue later, congruent goals who have a stake in M&A decisions. In a recent study of cross-border M&As, Steger and Kummer (2004) provide a comprehensive typology of stakeholders behind M&A transactions, including management, unions, employees, shareholders, the media and professional advisors, each group having their own agendas and aims. Amongst professional advisors are investment bankers, consultants, accountants, lawyers, advertising and public relations companies.

We posit that senior managers ('agents') and M&A advisors ('promoters') are key actors that directly influence M&A decisions and have the opportunity to appropriate value at the expense of shareholders. While shareholders are occasionally asked to approve acquisition decisions, and boards are responsible for making recommendations regarding potential acquisitions and, ultimately, for approving acquisitions, it is senior management (and particularly the CEO) who initiate and champion acquisitions. Empirical research has confirmed that boards approve the majority of proposals put forward by executives (McNully and Pettigrew, 1999). Other interest groups may also play a role in acquisition decisions (for example, regulators may prohibit a merger on antitrust grounds or a government may block a cross-border acquisition claiming national interests), but for reasons of clarity we exclude these actors as being peripheral to our discussion. The dynamic between the firm's actors is shown in Figure 1.

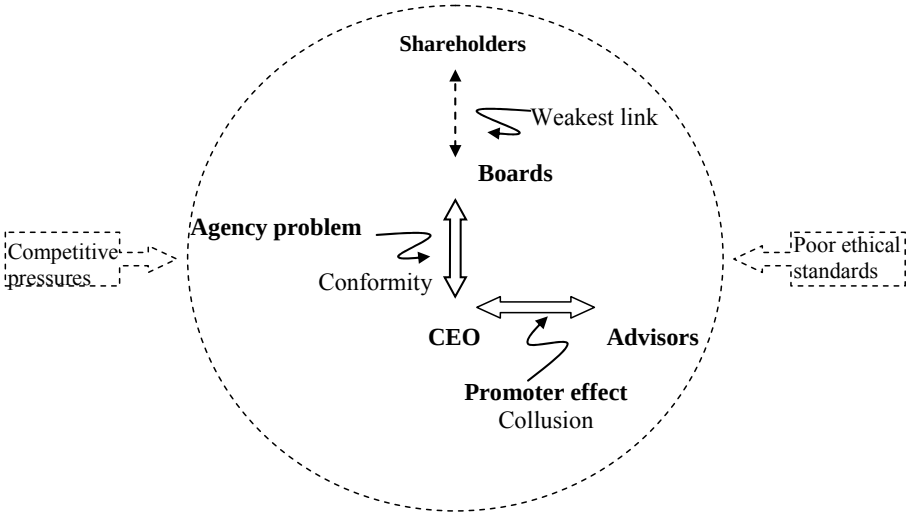

Fig. 1. The Nexus Dynamic

Theoretical Orientations: A Multi-Theoretic Approach

We construct our arguments using concepts from agency theory (Harris and Raviv, 1978; Fama and Jensen, 1983; Arrow, 1985; Jensen, 1986), institutional theory (e.g., DiMaggio and Powell, 1983), social embeddedness (e.g., Granovetter, 1985) and resource dependency perspectives (e.g., Pfeffer and Salancik, 1978). We draw on agency theory, because many of the contractual relationships in organizational research within and outside the firm boundaries have been traditionally investigated from the agency theory perspective (e.g., Arrow, 1985; Sharma, 1997). We note, however, that the firm is, in effect, a constellation of agents, and lumping them together under one broad category may obscure our understanding of underlying motivations and goals of each of these agents, which is why we find it necessary to differentiate between groups of agents.

We argue, though, that agency theory, in its own right, is inadequate to explain the 'merger preference' phenomenon. The main weakness of agency theory, as a theory with intellectual traditions in neoclassical economics, is an 'under-socialized' conception of human action and hence a limited attention to the role of social context in shaping economic action – an argument well developed by Granovetter (1985). Agency theory has been criticized for an unrealistic, overly simplistic view of organizations (Eisenhardt, 1989; Daily, Dalton and Cannella, 2003) and a disinclination to treat action as located within levels of analysis larger than the individual (Donaldson, 1990), possibly because this approach facilitates mathematical modelling and empirical testing. Hence, it would seem that agency theory is less insightful in explaining systems-level phenomena, such as how the firm interacts with its environment. Further, economic value that can potentially be created by a firm as a result of its M&A strategy is subject to bargaining, and its appropriation depends not only on opportunistic behaviors of individual agents, as agency theory would suggest, but on the relative bargaining power of the actors. Therefore, the joint lenses of institutional theory, and embeddedness and resource dependency perspectives would seem useful. These theories model organizations as open systems, all three of them explicitly dealing with the issue of organizational connectedness to the environment and the issue of power.

Agency theory, institutional theory, resource dependency and embeddedness perspectives may be seen as theoretical opposites, because they have different intellectual roots, explain different aspects of organizational life and are based on different assumptions about human nature, organizations and the role of the environment (see Table 1). Scholars, however, have strongly argued for a need to integrate these theories to more fully understand the organization-environment interface: for example, Baker (1990, p. 592) maintains that power and efficiency, the driving forces in sociology and economics, are empirically intertwined, and their distinctions are minor. Several empirical studies (e.g., Eisenhardt, 1988; Conlon and Parks, 1988) combine concepts from

institutional and agency theories. Social embeddedness of exchanges is also recognized by scholars whose studies are primarily informed by agency theory: for example, Sharma (1997) argues that social embeddedness is a distinctive attribute of professional work in the principal-professional exchange. To summarize, we believe that our multi-theoretic approach has merit and that these diverse theoretical perspectives should be seen as complementary, rather than incompatible.

Shareholders, Boards and CEOs: The Agency Problem

The relationships between shareholders, boards and CEOs have been the focus of much theoretical and empirical work in mainstream agency theory (e.g., Fama and Jensen, 1983; Oviatt, 1988; Eisenhardt, 1989; Davis, 1991), but for reasons of clarity it is necessary to briefly revisit the theory's main tenets. Agency theorists describe firms as legal fictions consisting of a 'nexus of contracts', where the stockholders are the suppliers of the factors of production in return for a residual claim on the uncertain, and possibly negative, difference between total revenues and costs at the end of each production period (Fama, 1980; Fama and Jensen, 1983). The relationship between firm management, boards and shareholders is an agency relationship, where rational actors – the agent and the principal – will seek to maximize their individual utility (Jensen and Meckling, 1976). The nature of this agency relationship hinges on the rational pursuit of self-interest and opportunism (Williamson, 1985), bounded rationality and risk aversion (Eisenhardt, 1989), the separation of ownership and control inherent in a modern corporation, and managerial discretion to control firm resources (Marris, 1964). The agency problem arises when the interests of the principal and agent are incongruent and is thus inherently associated with agency costs – that is, the costs of negotiating, structuring, monitoring, bonding and enforcing a set of contracts among agents with conflicting interests (Fama and Jensen, 1983, p. 304). These costs can be minimized by implementing a system of internal controls (such as budgets, information systems, rules and norms) and an appropriate reward structure designed to align the interests of both parties involved in an agency relationship. The primary foci of agency theory are the identification of various contract alternatives and the form of the most efficient contract under varying levels of outcome uncertainty, risk aversion and information asymmetry (Eisenhardt, 1989).

The board–shareholders nexus is the first construct in our model. The board of directors, as the agent of the shareholders, is at the apex of the firm's decision control system, charged with monitoring senior management to ensure that it fulfils its fiduciary duties of maximizing shareholder value (Fama and Jensen, 1983). A second important board function, according to resource dependence scholars (e.g., Pfeffer and Salancik, 1978), is the provision of advice and counsel (see also Daily *et al.,* 2003). We should note, however, that in practice this role is limited: board meetings are held infrequently (Pound, 1995; Kennedy, 2000), and, in the case of multinational firms, their frequency may be severely constrained by physical distance, if board members reside in different countries. Kennedy (2000) argues that a typical U.S. board meets nine times a year, with an average meeting lasting three hours. Outside of board meetings, board members spend less than two weeks a year on company-related matters.

The extent of boards' involvement in setting strategic direction is also open to debate, and a significant gap seems to exist between prescriptions that boards should be active in strategy and the empirical evidence (McNully and Pettigrew, 1999, p. 50). In a study of corporate governance practices in a number of European countries, Demb and Neubauer (1992) conclude that while there is little controversy whether setting strategic direction is a board's primary function, there is little consensus as to what precisely this function involves – initiating, approving or making decisions with regards to strategy.

As convincingly argued by Montgomery and Kaufman (2003), the board-shareholders nexus remains the weakest link in the corporate governance system: the information exchange between the two parties is poor, monitoring is weak, and shareholders have failed to exert much influence over boards. Such weak links create fertile ground for central actors (senior executives) to engage in opportunistic and unethical behaviors (see Brass, Butterfield and Skaggs, 1998). Consequently, we do not expect this nexus to have a substantial effect on constraining senior executives' merger preference and value appropriation. In fact, we argue that the effect is just the

reverse, because the nexus provides the fertile ground in which CEOs can pursue their own interests unencumbered by shareholder interests.

The relationship between senior executives and boards, the second nexus in our model, has been described by organizational scholars in somewhat contradictory terms. Outside board directors have been viewed either as effective monitors of management performance having the legal right and formal power to hire, evaluate, reward and fire senior managers (Fama and Jensen, 1983) and hence the ability to reduce agency costs or, at the other extreme, as ornaments on the corporate Christmas tree and passive tools of management (Davis, 1991). Regardless of the scholarly controversies surrounding the relationship of boards and senior management as well as the realities of increased shareholder activism, we argue that the boards' interests (at least in the Anglo-American setting) appear to be more congruent with the interests of senior management than those of the shareholders, particularly when the CEO–Chairman role is combined. Senior management and, above all, the CEO, while not possessing formal power over the board, may be able to exert influence on the board through co-optation, persuasion, selective use of information, control of the agenda, and even 'social influence', relying on norms of reciprocity, liking and social consensus to shape the board's decision-making (Wade, O'Reilly and Chandratat, 1990). Top executives also frequently use the board as a vehicle to legitimize decisions that may not be in the interests of the firms' shareholders (Tosi and Gomez-Mejia, 1989), such as paying high acquisition premiums.

While financial incentives are not a key motivator for board members (Montgomery and Kaufman, 2003), serving on a board of a firm which makes headline news because of an active acquisition strategy confers intrinsic benefits, such as prestige, status and a sense of belonging to an exclusive club (Westphal, 1999) – benefits which accrue to board members regardless of the economic outcomes of the mergers. Moreover, boards, through a network of interlocking directorates, may influence the decisions regarding the adoption and dissemination of various practices and strategies, including M&As, through inter-organizational imitation and social cohesion (Powell and DiMaggio, 1991; Haunschild, 1993; Mizruchi, 1996). Despite weaker private incentives for 'merger preference' and lesser direct opportunities for value appropriation, we argue that boards are more likely to conform to managerial decisions, driven by intrinsic benefits and network influences.

Given board conformity with managerial decisions and the weakness of the board–shareholder nexus, it is not surprising that the most enduring proposition in much organizational research has been that senior executives have broad discretion to pursue their own objectives, such as increasing company size through M&As to justify higher executive remuneration (Tosi and Gomez-Mejia, 1989). Based on the empirical evidence (e.g., Wade *et al.,* 1990; Zajac and Westphal, 1996) it can be argued that CEO contracts and reward structures are geared toward encouraging M&A activity.

To conclude, what we term 'merger preference' appears to be partially induced by the problem of CEO agency. The second determinant of 'merger preference' is the 'promoter effect' resulting from the CEO–advisor nexus, which, as we will argue below, is a critical, but overlooked, explanatory variable in shaping the M&A preference.

The CEO-Advisor Nexus: The Promoter Effect

The CEO–advisor nexus is located at the interface of the organization and its external environment. To cite Williamson (1991, p. 271), the parties to such relationships often "maintain autonomy but are bilaterally dependent to a nontrivial degree". Porter (1987) and DuBoff and Herman (1989) contend that, given their strategic position and the logic of self-interest, M&A advisors are able to reap disproportionate benefits from merger activity, with their fee structures positively related to the acquisition premiums and 'deal flow'.

Blending insights from agency theory and resource dependency perspectives helps us elucidate why professional advisors are able to appropriate value from firm shareholders. Advisors control three critical resources: know-how, information and access to capital. Decisions regarding M&As require a variety of highly technical analyses, such as financial valuation,

product-market analysis, tax issues and anti-trust considerations, which are beyond the in-house expertise of most firms (Haspeslagh and Jemison, 1992, pp. 58-64). Hence, professional advisors are able to exert significant influence over buyers of their services because of the asymmetry of specialist knowledge (see Sharma, 1997; Hayward, 2003). Further, advisors control access to investors through information: for example, a recent study indicates that almost 50% of the most important sources of acquisition targets come from professional firms (Angwin, 2001). In addition to information, investment banks are the gatekeepers to capital which, although a commodity, plays a central role in free market economy and is a key resource for acquiring firms (Baker, 1990). The use of advisors' fairness opinion may also provide some legitimation of the M&A decision for external stakeholders and even protection against shareholder lawsuits (Servaes and Zenner, 1996). Even though firms have been moving away from the relationship-oriented, quasi-hierarchical relationships with advisors, senior managers of many firms prefer to limit the number of providers of advisory services (Kosnik and Shapiro, 1997), thus contributing to a further increase in their power by building up buyer switching costs. The institutionalist perspective (Thompson, 1967) adds to these arguments by noting that organizations which depend on the same source for funding and legitimacy will be more subject to the whims of resource suppliers and can be coerced into accommodating the suppliers' needs.

Those scholars who study the relationship between principals and professional advisors (e.g., Sharma, 1997) contend that the agency perspective overstates the threat of advisors engaging in opportunistic behavior. Two reasons are put forward: the active involvement of firms (as clients) in the co-production of the service (Mills and Morris, 1986), often resulting in the development of mutual dependence and trust between the parties; and peer oversight through a system of controls, including the professional community and client control. We suggest, however, that these arguments are unsustainable in the specific case of the M&A advice. The weakness of the first argument is that professional firms are reluctant to share their M&A expertise with their clients – because this is precisely what gives them bargaining power in writing contracts and commanding high fees – and they are not directly accountable for M&A outcomes (Hayward, 2003). The effectiveness of peer oversight as a control mechanism in the professional community should also be seriously questioned: systematic empirical evidence suggests that professional firms have *consistently* recommended M&A practices that damage their clients' performance (see Tichy, 2001; Hayward, 2003). The existence of the so-called 'league tables' in the investment banking industry is another case in point: these tables give full credit to a bank for advice on an overpriced acquisition and have become the industry's primary marketing tool in the last decade.

One important relationship which appears to be overlooked by organizational scholars in the firm-advisor socioeconomic exchange is the nature of the personal CEO–advisor relationship. One point needs to be clarified here. Some scholars, consistent with the agency perspective, argue that the 'the firm' is the client in the principal–advisor exchange (Kesner, Shapiro and Sharma, 1994). What has been long evident to any industrial marketing scholar, however, is that the fictional 'firm' is not the client: it is the CEO, as the key decision-maker in the organizational buying centre, who, with the approval of the board, decides on acquisitions and buys associated advisor services.

Both parties to the CEO-advisor exchange make relationship-specific investments (Williamson, 1979), which are sunk costs, bonding the contracting parties together and creating a situation of mutual dependence. In the words of an investment banker (Shand, 2003, pp. 32-33), the most important relationship an investment banker can have is the relationship with the CEO, because it is the CEO who will buy the deal and who must then sell it to the board. The advisor will thus have to present himself as a source of wise and discreet counsel, able to persuade the CEO that the M&A deal is not *an* option, but *the only* option for the company. The CEO is often reliant not only on the advisor's professional expertise, information or capital, but on the latter's emotional support in her ambitions to quickly grow the company (Shand, 2003), affording even more control of the advisor over the CEO. On the other hand, advisors are dependent on the CEO for transactions and associated fees. Such co-dependence engendered by personal relations may present ample opportunities for malfeasance: the more complete the co-dependence, the greater the potential gain from malfeasance (see Granovetter, 1985: 491).

To summarize, our analysis of the CEO-Advisor nexus points to a relationship which, unlike the other relationships in the M&A decision-making nexus, display characteristics different from those assumed in principal-agent research. We propose that, far from being based on goal divergence or even congruence, the relationship between CEOs and M&A advisors takes the form of a mutually reinforcing, co-dependent relationship, in which both parties effectively collude against the 'ultimate principal' (the shareholders) to expropriate value. Such relationships, from the perspective of classical economics, are detrimental to organizational efficiency (Williamson, 1991).

The role of the environment

In our discussion so far we have argued that neither the agency problem between CEOs, boards and shareholders, nor the promoter effect associated with M&A advisors are, on their own, sufficient to induce 'merger preference' and the appropriation of value from shareholders. We argue that 'merger preference' is induced by the compounding effect of the CEO agency problem and the promoter effect, but its treatment would be incomplete without due attention to the role of the environment (see Figure 1).

Some scholars may argue that by assuming that senior executives and professional advisors will always behave opportunistically we are advocating an overly simplistic view of human nature in general (see Bartlett and Ghoshal, 1993; Ghoshal and Moran, 1996) and an unsympathetic view of managers and professionals in particular. Whether or not senior executives and advisors are more likely to act as stewards or altruistic professionals in the best interest of shareholders and clients should, however, be judged within a broader business and social context. Consider the following paradox: few senior executives, boards or investment bankers are self-serving villains. A typical profile of a CEO based on a random sample of one hundred CEOs of the 250 largest corporations in the US suggests that many of them are well-educated, bright, ambitious, hard working and competitive (Kennedy, 2000). Yet these CEOs, as suggested by scholars, practitioners and popular business press, have been turned into casino gamblers, encouraged to make their bets in a game of the American roulette where the chances of winning are 20%, and the only sure winner is the croupier (*The Economist*, 1999).

One likely explanation is that organizations and the social systems in which the organizations operate coexist in a web of complex, dynamic and symbiotic relationships (Epstein, 1999). Consistent with the open-systems perspectives, organizations and their members may adopt business practices irrespective of market efficiency (see DiMaggio and Powell, 1983; Palmer, Jennings and Zhou, 1993), ethical considerations (Donaldson and Dunfee, 1994) or even rationality (as long as practices *appear* rational) (Abrahamson, 1996). During the 1990s, the institutional environment in most Western economies was rewarding so-called 'winners' – large, fast-growing companies and their executives, the Wall Street 'Masters of the Universe', with ethical concerns and shareholders' rights being a remote afterthought. We submit that the nature of the CEO-advisors nexus is a telling example of economic behavior in an institutional environment – the 'merger preference' is a consequence of the dynamics of the system rather than 'bad people'.

As suppliers of professional advice, advisors do the best by their client (the CEO) and are not responsible to shareholders, while CEOs act according to the way they are rewarded. The CEO-advisors nexus, the focus of our discussion, is embedded in the context of increased competitive pressures in the organization's environment, equally affecting the client firms and professional advisors within the background of a crisis in business ethics of the 1990s. Hence, we contend that the problem of value appropriation and poor M&A economic outcomes goes beyond CEOs and advisors 'acting badly' (opportunistically). 'Merger preference' and the associated value appropriation are the structural outcomes of the nexus, with two interdependent variables – competitive pressures and ethical standards – having a moderating effect on the nexus dynamic in our model. It is reasonable to expect that even if the competitive pressures increase, but the institutional environment punishes non-compliance with ethical behaviors or puts rewards for conformity above those afforded by financial rewards (see Oliver, 1991), ethical standards will act as a constraint on value appropriation by the nexus members.

Discussion and implications

Contributions

Previous research has provided several theoretical rationales for the observed empirical paradox – that is, that managers of firms continue to pursue M&As regardless of the long-standing evidence that such strategies are value destroying. The model presented in this paper is a complementary explanation of the merger preference phenomenon and the resulting value appropriation. It is worth emphasizing that we do not dismiss other explanations put forward by management scholars, such as hubris, managerialism, escalation of commitment, need for global scale in many industries and, possibly, even management fashion: M&A decisions are complex phenomena, and it is likely that many motivations are at work at the same time. We have hypothesized, however, that a remarkable persistence with value-destroying M&A strategies may be due to the dynamic interaction between the agency problem and the promoter effect which induces the 'merger preference'. The key theoretical point is that the nexus between CEOs, professional advisors and boards provides a more compelling explanation for the observed 'merger preference' phenomenon than either the agency problem or the promoter effect on their own. Overall, we believe that we have extended the agency theory and provided reasonable explanations for the observed paradox. Our explanation raises a number of interesting practical, empirical and theoretical issues that are briefly discussed below.

Implications for practice

Our conceptualization of relationships within the shareholders–managers–advisors nexus has implications for business ethics and corporate governance practices. As long as the nexus between the CEOs and professional advisors exists, senior executives will continue to exhibit 'merger preference' and, in effect, collude against the shareholders in value appropriation.

Principal-agent theory offers two traditional safeguards against 'merger preference' – internal (e.g., boards and CEO compensation contracts) and external (the market for corporate control) corporate governance mechanisms (Oviatt, 1988). With regard to the internal mechanisms, we have argued that their effectiveness is mitigated in the specific context of M&As (for reasons such as poor information exchange between the boards and shareholders, CEO influence over the board, and his ability to influence the writing of employment contracts). It appears that the market for corporate control is an equally ineffective safeguard. By its very nature, it is an *ex post* control mechanism, and once shareholder value has been destroyed by a bad acquisition decision, the market for corporate control cannot exercise discipline on the CEO. A series of value destroying acquisitions may, in practice, lead to the market adopting a negative view of the firm's senior management and activating the external corporate governance mechanism. The problem with this agency theory argument is, however, that it is not always poorly performing companies are the targets for takeovers – it is successful, well-performing firms that are typically acquired (see Davis and Stout, 1992; and Ravenscraft and Scherer, 1988, for empirical evidence).

Given the inadequacy of corporate governance mechanisms, a possible solution to the problem is a return of business to ethical norms. Drawing on Donaldson and Dunfee's (1994, p. 258) arguments, we contend that ethical norms that inform economic life are artefacts of human agency, not products of nature, and can, therefore, be changed by people. Encouraging signs exist that corporate governance and ethics issues are coming increasingly under scrutiny around the world, which is likely to lead to the adoption and dissemination of practices in the interests of firm shareholders.

Implications for research and theory building

We recognize that the constructs in our model could be difficult to operationalize, as researchers will need to find meaningful proxies for 'collusion', 'conformity' and 'merger preference'. A useful starting point would be to establish patterns of ties (i.e., long-term, exclusive

ties or transaction-oriented ties) between firms and professional advisors in various institutional contexts and then to relate these patterns to M&A outcomes (see studies by Baker, 1990; and Hayward, 2003). Another way of dealing with the operationalization issue is to collect data on the known winners of the M&A strategies (CEOs and advisors), such as on their fees, salaries and other material and non-material gains from M&As (see DuBoff and Herman, 1989, p. 126).

A detailed clinical analysis of the dynamics of interaction between CEOs, professional advisors and boards within the context of M&A decision-making may be a first step towards operationalizing the concepts. Such analysis will involve significant methodological challenges: it is unlikely that researchers will be willingly invited into 'the black box' of the boardroom (Daily *et al*., 2003, p. 379) or to the discussion of the merger deals between firms and professional advisors for confidentiality reasons. Gaining access to organizations to study decision-making by board members and, more specifically, M&A decision-making is, however, possible, as demonstrated by Haspeslagh and Jemison (1992) and McNully and Pettigrew (1999) (even though the role of professional advisors and the senior management–board dynamics were not central problems in either of the studies). While challenging, the topic is worth pursuing to solve the long-standing puzzle that we have attempted to address in this paper.

To conclude, we believe that embedding agency models in larger systems of socio-political and cultural relationships and adopting an interdisciplinary approach presents a promising avenue for current and future theorizing. As Eisenhardt (1989, p. 70) notes, agency theory is a useful perspective when investigating organizational problems that have a principal-agent structure, but its explanatory power can be increased if it is used with complementary theories or extended into richer contexts. Organizational scholars have already recognized both the strengths and limitations of agency theory to explain empirical phenomena – studies by Eisenhardt (1988) and Sharma (1997), which incorporate a wider set of variables than the ones identified in agency theory, are good examples. In our view, open-systems perspectives on organizations (e.g., institutional theory) are likely candidates for theoretical complementarity.

Table 1

Assumptions of various theories

Theory	Key argument	Human assumptions	Organizational assumptions	Role of environment
Agency theory	Principal-agent relationships should reflect efficient organization of information and risk-bearing costs	Self-interest, opportunism, bounded rationality, risk aversion	Partial goal conflict among participants Efficiency as the effectiveness criterion Information asymmetry between principal and agent Goal conflicts are resolved through alignment of goals (use of incentives)	Organizational practices should fit environment
Resource dependency	Organizations are actively engaged in exchanges with the environment in order to improve performance and increase the chances of survival	(Boundedly) rational action and choice Behavior interdependence Outcome (symbolic and competitive) interdependence Individuals are adaptive to their environments	Power is emphasized over efficiency as primary motivation; organizations strive to reduce interdependence regardless of considerations of profit or efficiency Goal conflicts are resolved through use of power	Environmental forces influence organizational structures and decision-making Organizations are adaptable and are able to alter their environments The environment is the container of resources

Table 1 (continuous)

Theory	Key argument	Human assumptions	Organizational assumptions	Role of environment
Embeddedness	Economic action is embedded in concrete, on-going systems of social relationships	Mutual cooperation and trust in spite of the potential for opportunism	Power is emphasized over efficiency Goal conflicts between organizations are resolved through use of power	Social structures constrain, support or derail individual goal-seeking behavior
Institutional theory	Organizational practices arise from imitative forces and firm traditions	Satisficing, conformity to external norms and taken-for-granted ways of doing things	Connectedness (existence of transactions tying organizations to one another, formal and informal, contractual and non-contractual), structural equivalence Organizations do not only seek maximum efficiency, they adopt structures and processes reflecting the institutional environment	A source of practices to which organizations conform; legitimizes certain ways of organizing; gives prominence to legal and cultural factors that organizations face

Sources: Baker (1990), DiMaggio and Powell (1983), Eisenhardt (1988; 1989), Granovetter (1985), Oviatt (1988), Pfeffer and Salancik (1978), Pfeffer (1982), Portes and Sensenbrenner (1993), Scott (2003).

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