РАЗДЕЛ 2
СОВЕТ ДИРЕКТОРОВ

SECTION 2
BOARD PRACTICES

BOARD CHANGES FOLLOWING MERGERS

Donna L. Paul*

Abstract

This study documents an overall increase in board independence and size following completed mergers. The increase in board size is positively related to the size of the target firm, suggesting either that large targets have bargaining power to negotiate inclusion of their directors on the board of the merged firm, or that high target director representation is perceived to be vital in mergers of equals. The change in board independence is positively related to post-merger cash flow difficulty, suggesting that independent directors are more likely to be added if the firm faces financial constraints.

Keywords: *board restructuring, mergers, board independence, corporate governance*

**Washington State University, Pullman, WA 99164-4746*
Email: donna_paul@wsu.edu; phone: 509.335.8801; fax: 509.335.3857

1. Introduction

This study investigates changes in board composition following completed mergers. Combining the assets of a stand-alone firm with the bidder's assets is a significant corporate restructuring event that presents opportunities to redesign incentive systems. However, there is very little evidence on how boards change following mergers, and what determines those changes. Bris and Cabolis (2003) study international mergers and find that firms in general adopt better corporate governance practices following the merger. They also find a positive market reaction to the adoption of the system with better investor protection. In a study of a random sample of 583 U.S. firms, Denis and Sarin (1999) provide related evidence on how boards change over time and how major corporate events influence corporate restructuring. They investigate the determinants of changes in stock ownership and board composition, and find that board independence increases following corporate control threats. In view of the literature that independent boards are more likely to serve shareholders' interests (e.g., Byrd and Hickman (1992), Core Holthausen, and Larcker (1999)), I hypothesize that the significant restructuring of assets following a merger presents an opportunity for firms to adjust board structures towards greater independence.

Harford (2003) finds that 48% of merged firms in his sample increase board size following the merger, although only 13% of post-merger board seats are held by target directors. He also finds that, in general, the merger has a negative impact on target directors' stream of future directorships. Davidson, Sakr and Ning (2003) also document increases in board size following stock mergers, and find that directors of large targets are more likely to retain board seats following the merger. In light of this evidence that boards do change following mergers, I focus my analysis on the nature of these changes and the characteristics that influence them. Specifically, I investigate the impact of the characteristics of the acquiring firm, the target firm, and the deal itself, on changes in board independence and board size following the merger.

The sample comprises 145 firms completing mergers from 1982-1996. I find a mean (median) percentage increase in representation by independent outside directors of 8.8% (3.1%) and a mean (median) percentage increase in board size of 30.3% (28.6%). Three main results emerge from the empirical analysis of the determinants of changes in board size and independence. First, changes in board independence are significantly negatively related to levels of independence before the merger. This suggests that firms have desired levels of board independence and make adjustments over time towards this target. Second, there is a positive relation between announced difficulty in meeting debt obligations following the acquisition and the change in board independence. This is consistent with evidence in Gilson (1990) that financial distress leads to the reorganization of internal governance. It is also consistent with results in Denis and Sarin (1999) that board independence is likely to increase following external control events. Thus, it appears that internal and external control events prompt restructuring of board composition. Finally, increases in board size are greater for firms that acquire large targets, indicating the need to accommodate the directors of large targets. This could be driven by target directors' bargaining power for board seats or simply by the need for the expertise of target directors in mergers of equals.

The rest of the paper is organized as follows. The next section describes the sample selection and provides summary statistics. Section 3 contains an analysis of changes in board composition following mergers, and Section 4 contains a concluding discussion.

2. Sample

The sample comprises 145 public U.S. firms completing acquisitions of public U.S. targets from 1982 to 1996. This long sample period spans an active and inactive market for corporate control. It does not include the more recent period of corporate governance reforms, and thus the documented changes in board composition will not be influenced by the recent strident calls for corporate governance reform. Bidders and targets are identified from the target database in Schwert (2000). The initial sample comprises 422 bidders that are in non-financial and non-regulated industries. To reduce the cost of hand-collected board and post-bid event data, I randomly select a final sample of 145 firms. Changes in board structure are evaluated at the third fiscal year following the bid, and thus the sample excludes firms that do not survive to three years following the acquisition either due to takeover or bankruptcy.

Table 1 presents summary governance and financial characteristics for the sample of bidders. Board and ownership data are collected from proxy statements current at the time of the bid and financial data are collected from Compustat for the fiscal year-end preceding the bid. In evaluating board composition, I follow the literature and classify non-executive directors as independent outsiders if they have no business or family ties with the firm. Affiliated outside directors are non-executive directors that are not independent. Panel A of Table 1 indicates that sample firms have mean and median independent outside directors of 55.3% and 57.1%. The median number of directors on the board is 10 and officers and directors have a median equity stake of 7.1%. Fifty-four percent of firms in the sample have classified boards, in which directors are elected to three-year, rather than one-year, terms.

Sample firms have median book and market value of assets of 915 and 1,521 million and median book leverage of 19%. I measure relative target size as target market value of equity scaled by market value of bidder equity three months before the bid announcement. The median relative target size is 24%, which indicates that the acquisition is a significant asset restructuring event for most firms. Acquisition of a relatively large target is likely to induce changes in internal governance systems, and thus, the sample appears well-suited for an analysis of board changes following mergers.

Panel B of Table 1 contains various pair-wise correlations between the governance variables and provides insight into how these variables are interrelated. The discussion here focuses on the board size and board independence variables, which are the subject of this study. There is a highly significant negative correlation between independent outside director representation and affiliated outside directors, which is not surprising. If there are a fixed number of board seats available for outside directors, each seat filled by an affiliated outside director is lost by a potential independent outside director. Independent outside director representation is positively correlated with board size, a result that is modeled in Raheja (2006). It is possible that there are a select number of officers that typically occupy board seats (e.g. CEO, CFO, COO) and a select number of affiliated outsiders that are appointed to the board (e.g. corporate attorney, investment banker). Thus, board independence is likely to be positively correlated with board size because larger board size provides a greater number of residual board seats that can be filled by independent directors. Consistent with this, Denis and Sarin (1999) also find a significant positive correlation between board size and board independence in a random sample of 583 firms.

3. Changes in Board Structure following Mergers

This section documents the changes in board structure in the three years following the acquisition bid and investigates the determinants of these changes. Data on board structure are collected from two sets of proxy statements: the proxy statement current at the

time of the bid, and the proxy statement three years following the bid.

3.1 Univariate Analysis

Table 2 contains levels of board composition variables in the third fiscal year following the merger, and the level and percentage change from the fiscal year containing the merger to the third year following the merger. I evaluate changes three years following the acquisition in order to provide enough time for board and ownership structures to stabilize following the combination of bidder and target assets. The results show a significant mean (median) increase in board size of 3.2 (3.0) directors. Denis and Sarin (1999) study a random sample of 430 firms and do not find significant changes in board size over time. In contrast, Boone, Field, Karpoff, and Raheja (2006) find an increase in board size and independence in the 10 years following IPO. The increase in board size for the sample of completed acquisitions therefore suggests that material board changes tend to occur following significant corporate events.

There is also a significant mean (median) increase in outside director representation on the board of 2.2 (2.3). This is consistent with the positive correlation between board size and board independence in Panel B of Table 1. It suggests that larger board size facilitates the inclusion of additional independent outside directors on the board. Thus, as sometimes argued in the literature, a large board size is not necessarily inconsistent with shareholder interests if it facilitates greater board independence. This result will be explored further in the multivariate analysis.

An increase in board independence is potentially beneficial to shareholders based on empirical evidence that board independence is positively related to firm performance and to managerial responses to poor performance. Byrd and Hickman (1992) find that firms whose boards are dominated by independent outside directors earn higher bid announcement returns. Weisbach (1988) finds that CEOs of firms with poor prior performance are more likely to be dismissed when the board is dominated by independent outside directors, and Paul (2006) finds that board independence influences corrective managerial responses to poor bid performance. Thus, the evidence of an increase in board independence following the bid suggests that mergers provide opportunities for boards to restructure in ways that might be beneficial to shareholders.

Table 3 further examines the interrelations among changes in board and ownership in a correlation matrix. The highly significant negative correlation of -0.4523 (p-value<0.0001) between pre-merger board independence and post-merger growth rates in independence indicates that bidders with more independent boards have lower growth rates in board independence than bidders with less independent boards.

3.2 Model Design for Multivariate Analysis

To further examine the nature of changes in board structure following mergers, I estimate two sets of ordinary least square (OLS) regression models. I focus the analysis on changes in board size and board independence following the completed merger. The dependent variable in the first set of models is the percentage change in board independence from the fiscal year of the acquisition to the third fiscal year following the acquisition (Table 4). The dependent variable in the second set of models is the percentage change in board size over this same period (Table 5).

In light of evidence in Table 3 that post-bid changes are correlated with pre-bid levels, I include pre-bid board size and board independence as explanatory variables. In models that estimate changes in board independence, I also include changes in board size on the right-hand-side, and in models that estimate changes in board size, I include changes in board independence as an independent variable. I also control for pre-bid levels and post-bid changes in officer and director share ownership, and include a dummy variable if the firm has a classified board. The models include other variables to control for their potential effect on board restructuring following acquisition bids. Relative size of target represents the potential impact of the target board structure on the internal governance structure of the combination. It is possible that some restructuring of the board is related to the market's perception of the deal. Thus, I include the bid announcement return to control for the effect of the market's valuation of the bid on post-bid board restructuring. The bid announcement return is measured by cumulative market model residuals (CARs), from five days before and one day following the bid announcement day. Market model parameters are estimated from 300 to 61 trading days before the bid announcement day, and the value-weighted *CRSP* index is used as a proxy for the market.

It is possible events that occur following the merger influence the nature of of post-merger board restructuring. It is also possible that firms restructure boards when faced with financial constraints. Thus, additional variables are included to control for the effect of pre-bid financial characteristics and post-bid events. To capture the degree of financial constraints, I include pre-bid financial leverage and a dummy that equals one if the firm encounters cash flow difficulty subsequent to the bid. Other control variables include pre-bid book value of assets and market to book value of assets. Dummy variables for events that are likely to influence changes in board structure following the merger are also included. The *external asset acquisition* dummy takes on a value of one if the firm announces additional acquisition activity following the bid. The *corporate control event* dummy equals one if the firm experiences external shareholder targeting, such as takeover bids, proxy fights or

shareholder suits following the bid. Financial variables are collected from Compustat and announcements of cash flow difficulty, subsequent acquisitions, and corporate control events are collected from the *Wall Street Journal Index* for the three years following the acquisition announcement.

3.3. Determinants of Changes in Board Independence

The dependent variable in Table 4 is the percentage change in board independence in the three years following the bid. Model (1) estimates a regression with only pre-bid board independence and firm size as independent variables. There is a negative and highly significant coefficient of 0.75 on pre-bid board independence. This indicates that the higher the pre-merger board independence, the lower the change in independence. This suggests that boards that were already highly independent remain that way after the merger. The negative coefficient is also consistent with the interpretation that the greater is board independence at the time of the bid, the more likely is a decrease in independence, suggesting mean reversion in board independence, which could be interpreted as movement over time towards some target board structure.

Model (2) includes as explanatory variables both levels and changes in board size and managerial ownership, and also includes financial characteristics such as market to book, leverage, and the growth in firm size following the acquisition. The negative and highly significant coefficient on pre-bid board independence persists. However, the change in board independence is positively related to the growth in board size. This evidence indicates that increases in board size facilitate the appointment of non-officer directors to the board. It is consistent with the idea that there are a fixed number of board seats that are typically occupied by officers and affiliated outside directors. As board size increases, the more likely is an increase in the presence of independent outside directors. This is consistent with the results in Table 2 that 2 out of 3 new board members are independent.

Yermack (1996), Eisenberg, Sundgren and Wells (1998), and Del Guercio, Dann and Partch (2003) find a negative relation between board size and various proxies for firm performance. However, the evidence in Model (2) suggests that increases in board size allow for appointment of relatively higher proportions of independent outside directors. This indicates that the effect of board size on firm performance must be evaluated jointly with other aspects of board structure. Model (2) also indicates a negative relation between the post-merger growth in total assets and changes in board independence. The larger the size of the target, the greater would be the growth in assets. Thus, the result indicates that the larger the size of the target, the smaller the change in board independence.

In Model (3) of Table 4, I include bid characteristics (relative target size and bid CAR) and post-bid corporate event dummies (subsequent acquisitions, external targeting, and cash flow difficulty) as explanatory variables. The coefficient on pre-bid board independence retains its size and significance, suggesting that mean reversion is an important source of changes in board independence over time. The coefficient on the asset acquisition dummy is positive and significant, indicating that firms that are serial acquirers are more likely to increase board independence. The cash flow difficulty dummy is positive and significant, indicating a positive relation between threatened financial distress and an increase in board independence. This is consistent with results in Gilson (1990) of an increase in representation by expert outside directors following bankruptcy.

3.4. Determinants of Changes in Board Size

Table 5 contains OLS coefficient estimates of percentage changes in board size following the acquisition. Model (1) suggests that firms with larger boards to have a slower growth rate in board size, with a coefficient on pre-bid board size of -0.12 and a p-value of 0.086. However, results from other models in the table indicate that this effect is not robust to the inclusion of other explanatory variables. Model (2) indicates a positive relation between the growth in board independence and the growth in board size.

Model (3), which includes the variables for bid characteristics and post-bid events, indicates that relative target size is positively related to changes in board size. This indicates that the larger the target, the greater the need to increase board size in order to accommodate target directors on the board of the new merged firm. It is consistent with results in Davidson et al (2003) and indicates that larger targets have greater bargaining power for retention of board seats on the merged firm. The evidence in Table 4 shows that relative target size is not significantly related to changes in board independence. Viewing this together with the evidence in Table 5 for relative target size suggests that executives of large target firms (rather than independent directors) have greater bargaining power and are able to negotiate board seats on the merged firm.

Model (3) also indicates a negative relation between bid CAR and changes in board size following the bid. Large board size is considered by some (e.g. Yermack (1996)) to lead to possible inefficiencies that hinder value maximization. In this context, the negative coefficient on bid CAR suggests that firms with the worst bid performance are more likely to adopt a board structure that may not be in shareholders' best interests. However, many recent papers (e.g. Coles, Daniel, and Naveen (2006)) challenge the notion that large board size necessarily indicates inefficiencies, and instead argue that firms with certain asset characteristics require larger boards. Thus, the negative sign on the bid announcement

return is consistent with the intuition that firms add directors following "bad" bids to aid in strategic realignment.

The positive and significant coefficient on the asset acquisition dummy indicates that serial acquirers increase board size in order to accommodate some directors of acquired firms. It is consistent with the result in Table 4 that changes in board independence are positively related to making subsequent acquisitions. That is, as boards increase in size following acquisitions, there are opportunities to add independent directors to the board.

The final model in Table 5 repeats the analysis in Model (3) after excluding outliers for relative target size as described in the previous section. In this subsample, the bid CAR and the post-bid acquisition dummy are no longer significant. However, the result that the acquisition of large targets is associated with increases in board size persists.

4. Conclusion

This study investigates changes in board composition following acquisition bids using a sample of 145 firms completing acquisitions from 1982 to 1996. Results indicate an overall increase in board independence and board size. The mean (median) percentage increase in representation by independent outside directors is 8.8% (3.1%) and the mean (median) percentage increase in board size of 30.3% (28.6%).

The analysis of board changes following acquisitions produces three main results. First, there is a negative relation between pre-bid board independence and post-bid changes in board independence. This indicates that firms with greater pre-bid board independence have lower growth rates in independence, suggesting that there might be limits to the benefit from board independence. Second, there is a positive relation between post-bid financial distress and the change in board independence, consistent with evidence in Gilson (1990) and Denis and Sarin (1999) that firms often restructure internal governance when faced with financial distress. Finally, the increase in board size is greater for firms that acquire large targets, suggesting that target directors' bargaining power for board seats is increasing in their relative size.

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Appendices

Table 1. Descriptive Statistics

The sample comprises 145 firms completing merger or tender offer bids from 1982-1996. Financial data are measured at the end of the fiscal year preceding the bid announcement. Board and ownership data are from proxy statements current at the time of the bid. Outside directors are directors that are not current or former officers of the firm. Affiliated outside directors are directors with either family or business ties to the firm, and independent outside directors are outside directors with no such ties. Market value of assets is market value of equity plus book value of liabilities plus carrying value of preferred stock. Relative target size is target market value of equity scaled by bidder market value of equity three months before the bid.

Panel A: Levels of Board and Financial Variables

	Mean	Median	Standard Deviation
Independent outside directors (%)	55.33	57.14	18.66
Affiliated outside directors (%)	9.60	0.00	13.50
Number of directors	10.90	10.00	3.70
Officer & director ownership (%)	15.35	7.11	18.42
Number with Classified board	53.79	n/a	50.03
Book value of assets (MM$)	2522.53	915.38	4134.60
Market value of assets (MM$)	3783.87	1521.16	6043.94
Long-term debt/total assets (%)	21.25	19.00	14.57
Relative target size (%)	51.49	23.95	111.53

Panel B: Correlation Coefficients (p-values in parentheses)

	Independent outside directors	Affiliated outside directors	Number of directors	Officer & director ownership	Book value of assets
Classified board	0.1016	-0.0704	0.0020	-0.1673	-0.0399
	(0.2240)	(0.3998)	(0.9810)	(0.0443)	(0.6338)
Independent outside directors		-0.5192	0.1537	-0.4637	0.0945
		(0.0000)	(0.0649)	(0.0000)	(0.2583)
Affiliated outside directors			0.0457	0.2661	-0.0485
			(0.5855)	(0.0012)	(0.5626)
Number of directors				-0.2342	0.4754
				(0.0046)	(0.0000)
Officer & director ownership					-0.3215
					(0.0000)

Table 2. Changes in Firm Size, Board Composition, and Managerial Ownership

The table contains mean and median post-acquisition levels and changes in book value of assets, board and ownership variables in the third year following completed acquisitions. P-values are in parentheses and denote whether the changes are significantly different from zero.

	Mean			Median		
	$Level_{t+3}$	$Change_{t=0, t+3}$	$\%\ Change_{t=0, t+3}$	$Level_{t+3}$	$Change_{t=0, t+3}$	$\%\ Change_{t=0, t+3}$
Independent outside directors (%)	57.56	2.24 (0.000)	8.81 (0.000)	57.14	2.27 (0.000)	3.12 (0.000)
Number of directors	14.10	3.19 (0.000)	30.27 (0.000)	14.00	3.00 (0.000)	28.57 (0.000)
Officer & director ownership (%)	13.22	-2.25 (0.005)	0.40 (0.961)	5.40	-0.25 (0.014)	-11.34 (0.699)
Book value of assets	4908.24	2355.71 (0.000)	186.75 (0.000)	2082.15	769.54 (0.000)	83.92 (0.000)

Table 3. Correlation Coefficients for Pre-Acquisition Levels and Post-Acquisition Changes in Board Variables

The table contains correlation coefficients between the pre-acquisition level and post-acquisition percentage change in board and ownership variables in the third year following completed acquisitions. P-values are in parentheses and denote whether the coefficients are significantly different from zero.

	Growth in independent outsiders	Growth in board size	Growth in O&D ownership
Independent outside directors$_{t=0}$	-0.4523 (0.0000)	-0.0119 (0.8874)	0.0452 (0.5895)
Number of directors $_{t=0}$	-0.1192 (0.1536)	-0.1420 (0.0885)	0.0653 (0.4350)
Officer & director ownership $_{t=0}$	0.2614 (0.0015)	-0.0160 (0.8484)	-0.1974 (0.0173)
Growth in independent outside directors		0.1346 (0.1066)	-0.1235 (0.1390)
Growth in board size			0.0670 (0.4231)

Table 4. OLS Coefficient Estimates of Changes in Board Independence

The dependent variable is percentage change in board independence in the three years following the bid. The sample comprises 145 firms completing acquisitions from 1982-1996. Board and ownership variables for t=0 are taken from proxy statements current at the time of the bid; board variables for t=3 are taken from the proxy statement in the third year following the bid. Financial variables are for the fiscal year end preceding the bid. P-values are in parentheses after the coefficient estimates and denote significantly different from zero using a two-tailed test. *, **, and *** indicate coefficient estimates are significant at the 10%, 5%, and 1% levels, respectively.

	Model (1)	Model (2)	Model (3)
Independent outsiders$_{t=0}$	-0.7498*** (0.0000)	-0.7375*** (0.0000)	-0.7045*** (0.0000)
Log (Board size$_{t=0}$)		-0.0355 (0.7150)	-0.0398 (0.6780)
Growth in board size$_{t=0, t+3}$		0.2428** (0.0360)	0.1567 (0.1857)
Classified board dummy		0.0882* (0.0662)	0.0657 (0.1643)
Officer & director ownership$_{t=0}$		0.1849 (0.2585)	0.1257 (0.4382)
Growth in O&D ownership$_{t=0, t+3}$		-0.0051 (0.3499)	-0.0037 (0.4804)
Market to book$_{t=0}$		0.0638* (0.0782)	0.0571 (0.1183)
Long-term debt$_{t=0}$ / total assets$_{t=0}$		-0.0048 (0.9780)	-0.0987 (0.5702)
Book value of assets$_{t=0}$	-0.0047 (0.7750)	0.0047 (0.8444)	-0.0116 (0.6302)
Growth in book value of assets$_{t=0, t+3}$		-0.0135** (0.0425)	-0.0144** (0.0334)
Relative target size			0.0044 (0.8476)
Bid CAR			-0.4892 (0.1297)
External asset acquisition dummy			0.1124* (0.0506)
Cash flow difficulty dummy			0.1766** (0.0200)

Corporate control event dummy			0.0681
			(0.2308)
Intercept	0.5354	0.3261	0.3788
	(0.0000)	(0.1877)	(0.1365)
Number of observations	145	145	145
Adjusted R^2	0.1938	0.2327	0.2761

Table 5. OLS Coefficient Estimates of Changes in Board Size

The dependent variable is the percentage change in board size in the three years following the bid. The sample comprises 145 firms completing acquisitions from 1982-1996. Board and ownership variables for t=0 are taken from proxy statements current at the time of the bid; board variables for t=3 are taken from the proxy statement in the third year following the bid. Financial variables are for the fiscal year end preceding the bid. P-values are in parentheses after the coefficient estimates and denote significantly different from zero using a two-tailed test. *, **, and *** indicate coefficients are significant at the 10%, 5%, and 1% levels, respectively.

	Model (1)	Model (2)	Model (3)
Log (Board Size$_{t=0}$)	-0.1189*	-0.0825	-0.0735
	(0.0865)	(0.2506)	(0.3004)
Independent outsiders$_{t=0}$		0.0963	0.1282
		(0.4054)	(0.2632)
Growth in Independent outsiders$_{=0, t+3}$		0.1334**	0.0864
		(0.0360)	(0.1857)
Classified board dummy		-0.0503	-0.0494
		(0.1583)	(0.1584)
Officer & director ownership$_{t=0}$		-0.0912	-0.0848
		(0.4527)	(0.4815)
Growth in O&D ownership$_{t=0, t+3}$		0.0030	0.0034
		(0.4498)	(0.3870)
Market to book$_{t=0}$		-0.0022	0.0088
		(0.9357)	(0.7477)
Long-term debt$_{t=0}$ / total assets$_{t=0}$		-0.0833	-0.1132
		(0.5210)	(0.3801)
Book value of assets$_{t=0}$	0.0085	0.0039	-0.0100
	(0.5846)	(0.8246)	(0.5760)
Growth in book value of assets$_{t=0, t+3}$		0.0081	0.0026
		(0.1037)	(0.6120)
Relative target size			0.0356**
			(0.0369)
Bid CAR			-0.4266*
			(0.0747)
External asset acquisition dummy			0.1053***
			(0.0133)
Cash flow difficulty dummy			-0.0261
			(0.6461)
Corporate control event dummy			0.0535
			(0.2048)
Intercept	0.5219	0.4478	0.3915
	(0.0000)	(0.0139)	(0.0374)
Number of observations	145	145	145
Adjusted R^2	0.0116	0.0204	0.0723