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PROFESSIONAL INFLUENCE: THE EFFECTS OF INVESTMENT BANKS ON CLIENTS' ACQUISITION FINANCING AND PERFORMANCE

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This study examines the conditions in which professional firms use client engagements to get clients to subsequently hire them. The central thesis is that professional firms derive power from their specialized expertise and lead clients towards complex problems that apply the expertise. In particular, relative to cash-financed acquisitions, stock-financed acquisitions more intensively apply investment banks' expertise. Consistent with expectations, results from a sample of 404 acquisitions show that firms are more likely to hire banks on stock-financed acquisitions when they have previously used banks. Evidence also suggests that clients that hire banks on such acquisitions are prone to adverse performance from them. Overall, these results suggest that professional firms lead clients to complex solutions with problematic outcomes. Copyright © 2003 John Wiley & Sons, Ltd.

According to some estimates, professional firms generate over 15 percent of U.S. gross domestic product (Statistical Abstract of the United States, 1998). The prominence of professional firms in Western societies underscores the continued need for theory and evidence on the nature and implications of professional action.

Organizational theories offer divergent perspectives on such nature. On the one hand, institutional theorists often cast these firms as active and impartial conduits of organizational practices (DiMaggio and Powell, 1983). Studies show that investment banks and accounting firms, amongst other professional firms, are instrumental in diffusing those practices (Mezias, 1990; Haunschild, 1994). Less clear is how the practices originate, including the role played by professional agency. On the other hand, professions and their member firms and individuals are sometimes cast as guileful, manipulative, and self-serving. According to the sociology of professions literature, professions and their member firms strive to protect and extend their professional jurisdictions (Abbott, 1988; Kesner, Shapiro, and Sharma, 1994; Larson, 1977). Members do this by developing, controlling, and deploying abstract knowledge that they use to control interactions with each other and clients (Blau, 1984; Eccles and Crane, 1988; Edelman, 1990; Hall, 1967; Lowendahl, 1997; Thomas and Mungham, 1983). By virtue of these interactions, professional firms can set the agenda for the adoption and implementation of their favored practices (Abrahamson and Fairchild, 1999).

This article adopts the latter perspective in addressing three questions: What is the nature of professional firms' influence? When do professional firms exert influence? And, third, what are the implications of the influence? In particular, the study here combines insights from the literature on (a) the sociology of professions to establish the basis of professional influence

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and (b) organizational power to establish when that influence is exercised. The central thesis that emerges from this theorizing is that professional firms use client engagements to win repeat work that utilizes professional expertise. In particular, professional firms' abstract knowledge is the source of their expert power over clients (French and Raven, 1968; Pfeffer, 1981). Existing engagements are principal forums for professional firms' access to clients. In turn, such firms gain opportunities to get clients to attend to future problems that require professional expertise (Blau and McKinley, 1979; French and Raven, 1968). Further, the extent of expert power that professional firms can exert over clients positively relates to the strength of such firms' client relationships.

This thesis is examined within the context of the advice that investment banks offer clients on acquisition financing. A critical choice that firms make in these acquisitions is how to finance them. For various reasons that will be elaborated, banks can more extensively apply their knowledge of and expertise in equity securities in stock- vs. cash-financed acquisitions (Brealey and Myers, 1996; Servaes and Zenner, 1996). This choice matters because stock-financed acquisitions are shown to underperform cash-financed ones (e.g., Asquith, Bruner, and Mullins, 1987; Franks, Harris, and Titman, 1991; Loughran and Vijh, 1997; Travlos, 1987). For example, one study of 947 acquisitions undertaken between 1970 and 1989 showed that firms using stock-financed acquisitions experienced negative returns of 25 percent during a 5-year period after the acquisition vs. positive returns of 62 percent for cash-financed acquisitions (Loughran and Vijh, 1997). Such performance underscores the importance of examining banks' influence on clients' acquisition financing choices and the outcomes from such choices.

To establish the boundaries of this article, it is important first to emphasize that professional firm engagements take on three main forms. First, clients often outsource work because they lack the resources or interest to complete it themselves. Second, clients may want to use professional firms as 'rubber stamps' to convey to public audiences that they have acted as careful fiduciaries (Meyer, 1994; Pfeffer, 1981). This article is concerned with a third, mid-range scenario in which clients do not outsource work to professional firms, but elicit professional advice to extract better performance from material decisions (Eccles and Crane, 1988; Maister, 1993).

Discussion now turns to theory on the sociology of professions and organizational power to examine how professional firms exact influence.

THEORY

A point of departure is that professional firms yield revenue and work prospects from existing engagements (Hall, 1967; Lowendahl, 1997). Yet, those prospects often fail to materialize. Over time, professional expertise becomes more routine and widely held, causing its value to depreciate (Abbott, 1988; Larson, 1977). Rival professions and professional firms encroach on incumbents' jurisdictions by attaining or supplanting such expertise. For instance, management consultants and accountants now vigorously compete with banks for mergers and acquisitions advisory work. Demand for professional firms diminishes as professional knowledge becomes more diffuse, transparent, and accessible to in-house experts and lay people. To illustrate, acquiring firms increasingly undertake the pricing, financing, and negotiating of acquisitions in-house (McConville, 1996). Therefore, total fees generated by banks from acquiring clients have failed to grow in proportion to the boom in acquisition activity during the 1990s (*Mergers and Acquisitions*, 1999).

In response to these types of challenges, professions and their member firms seek control over clients. They do so by developing, controlling, and applying abstract knowledge (Abbott, 1988; Freidson, 1986; Larson, 1977). Whereas common knowledge is the everyday awareness of issues, abstract knowledge refers to the routines with which professional firms diagnose and treat problems and draw inferences about them. Abstract knowledge is the defining feature of professional firms because it underscores professional expertise and the demand for professional services. Armed with abstract knowledge, professionals can highlight and define problems with language that allows them to apply and control that knowledge. Otolaryngologists may persuade patients that they have 'tonsillitis' rather than a throat infection; litigators may persuade clients that they have been 'defamed' or 'damaged', rather than inconvenienced, and so forth (Freidson, 1970; Nelsen and Barley, 1997).

More generally, these examples highlight that professional firms generate revenue by getting clients to engage in problems that utilize professional expertise. Existing client engagements are principal opportunities for professional firms to alert clients both to those problems and to the utility of professional expertise (Freidson, 1986; Giddens, 1984; Pfeffer, 1981). As examples, consulting firms use engagements to persuade clients that they have ongoing strategy problems (Maister, 1993), investment banks use acquisitions to alert clients to future financing and acquisition opportunities (Abbott, 1988; Eccles and Crane, 1988) and so on.[1] That is, if professional firms are influential, their clients will engage in problems that require professional expertise (French and Raven, 1968).

Research documents the many artful ways in which professional firms manage client relationships to exact such influence. Amongst other things, professional firms make relationship specific investments in clients, say, by researching client problems and investing in client executives and communication channels (Abbott, 1988: 40; Dingwall, 1983; Edelman, 1990; Nelsen and Barley, 1997; Van Maanen and Barley, 1984). Then, as professional firms cement client relationships, they become more able to regulate and routinize their interactions with clients (Baker, 1990; Levinthal and Fichman, 1988). In turn, this increases the costs to clients of switching to another professional firm or working independently. For professional firms, the pay-offs include more work under better terms, including retainer arrangements (Berger, Cohen, and Zelditch, 1972; Goode, 1957, 1978; Levinthal and Fichman, 1988).

To summarize, professional firms use client engagements to win repeat work that applies professional expertise. Testing this reasoning involves identifying a setting in which clients engage in recurring action on which they hire professional firms. Acquisition financing is one such setting because large firms make multiple acquisitions that must be financed; and frequently use banks to advise on the choice. Further, as discussed, this choice materially impacts acquisition performance. The following section examines how banks' knowledge and expertise is more applicable in stock rather than cash-financed acquisitions (Eccles and Crane, 1988), such that acquiring firms tend to hire banks on stock but not cash financed acquisitions (Servaes and Zenner, 1996).[2]

RESEARCH SETTING AND HYPOTHESES

Banks' work with clients and acquisition financing

The decision of whether or not to hire a bank is the prerogative of acquiring managers (Gilson and Black, 1995). Banks advise acquiring firms on the pricing, financing, and negotiating of acquisitions (Eccles and Crane, 1988; Haunschild, 1994). As a Merrill Lynch banker described in his work on British Petroleum's 1998 merger with Amoco, 'Our advisory work (for BP) consisted of investigating the feasibility of the stock issue and the attractiveness of the equity issued' (Thomas, 1998: 6). Banks also value, market, and place debt securities. But, for regulatory reasons, commercial and investment banks have historically worked on debt- and stock-based securities respectively.

Relative to cash-financed acquisitions, stock-financed acquisitions are complex transactions that more extensively utilize banks' abstract knowledge and thus expertise. Whereas cash-financed acquisitions require valuation of the target's stock, stock-financed acquisitions require valuation of (a) the target's stock, (b) the acquiror's stock, and (c) an exchange rate that persuades target shareholders to exchange their stock for that of the acquiror. Once clients choose stock, banks can then advise them on whether to choose a 'fixed exchange rate' or 'fixed value' pricing. Whereas a fixed exchange rate specifies a fixed ratio for exchanging shares (e.g., one for one), fixed value pricing specifies the value of the target's shares, which ultimately determines the exchange rate. Whatever the exchange rate, the success of stock-financed acquisitions hinges on the attractiveness of the acquiror's stock as a currency of exchange. Because such stock price changes after the acquisition announcement, it is more difficult to value than cash. Banks can then deploy the specialized knowledge required to value uncertain equity securities and their derivatives (Cox and Rubinstein, 1985; Gilson and Black,

[1] To further illustrate, doctors' referral systems reinforce to patients that they have medical problems, creating demand for specialists as well as for those who refer them (Abbott, 1988; Goode, 1957).

[2] Naturally, there are many determinants of acquisition financing and bank influence is only one. Whereas later discussion elaborates these other key determinants (e.g., Martin, 1996), the following is limited to the role of bank influence.

1995; Levine, 1988).[3] Once the valuation is made and the terms of the stock offer are set, banks draw on their extensive network of equity investors to market and place the securities (Eccles and Crane, 1988). While brief, this discussion highlights why (a) stock-financed acquisitions are more complex than cash-financed ones (see Brealey and Meyers, 1996, for a review) and (b) banks are more extensively used on these former transactions (e.g., Servaes and Zenner, 1996).

The implication is not that banks always promote stock- over cash-financed acquisitions. Rather, it is that banks will, on average, use acquisition work to get clients to hire them on subsequent stock-financed acquisitions. Put another way, firms choose whether to use (a) stock or cash and (b) a bank or not as depicted in the matrix shown in Figure 1.

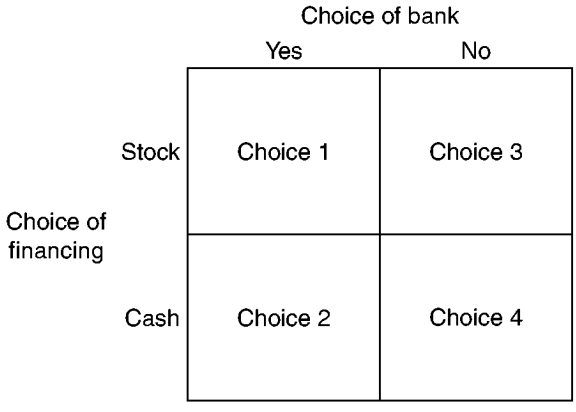

Figure 1. Acquiring firm's choice of bank and financing

[3] Consider, as examples, takeover 'derivatives' and 'insurance' products. Derivative products are applicable in stock-financed acquisitions because they protect acquirors from fluctuations in their stock price between the time a bid is announced and when it closes (Amobi, 1997). While takeover derivatives take many forms, one is price floors and ceilings (see Amobi, 1997, for a review of the many derivative products). To illustrate, in 1997, IVAX bid for Johnson Products with a one-for-one fixed exchange ratio. IVAX wanted the offer to hold only if its own share price stayed between $24.50 and $29. Thus, the company included a clause to adjust the offer if its stock fell below $24.50 (the offer is insufficiently attractive to Johnson shareholders) or rose above $29 (the offer is too generous to Johnson shareholders). Part of banks' work is to evaluate whether stock financing can insure acquirors against overvaluing or undervaluing the target. When the acquisition is completed, target shareholders join acquiror shareholders in the larger firm and hence share in the effects of any undervaluation or overvaluation of the target (see Brealey and Myers, 1996: 926–927, for a summary and review). In the case of overpayment, target shareholders attain both a favorable exchange rate as well as shares that may later fall in value.

Choice 1 in Figure 1 is a joint outcome that most extensively applies banks' expertise because it allows banks to utilize and demonstrate their knowledge of equity securities.[4] This then increases the likelihood that banks will win yet further similar work.

If banks use prior engagements to influence such outcomes, what is the nature of their influence? At the one extreme, it may be discursive and overt, presenting in bankers' representations, including public ones. Notwithstanding evidence of losses from stock-financed acquisitions, prestigious Wall Street bankers assert the following:

> An acquiror can afford to pay premium prices for premium targets when it uses its highly valued currency to fund a portion of the purchase price (Goldman Sachs, Vice President, *Mergers and Acquisitions*, 1999: 11)
>
> I think that we have to realize that people are just trading one currency for another. Even for larger deals, depending on the relative sizes of the acquiror and target, stock offers have an advantage ... (Bear Stearns, Vice President, *Mergers and Acquisitions*, 1999: 14)

At the other extreme, such influence may be more covert, presenting implicitly in the interactions between bankers and their clients. Bankers may deftly show how their expertise is instrumental in stock financing, even if those skills cannot overcome acquisition losses (Kelley, 1971). Here, influence is less a conscious act than 'a regular and routine phenomenon' (Giddens, 1979: 91).

Whatever the nature of the influence, banks have reason and opportunity to use existing work to lead existing clients to stock-financed acquisitions (choice 1 in Figure 1). Conversely, firms that have not worked with banks on prior acquisitions are less exposed to bank influence and so less likely to make such choice. To return to theory from the sociology of professions, professional firms and their workers arrive at similar solutions because they share training, problem-solving experiences and, social networks. Thus, hiring any bank exposes a firm to bank influence processes, increasing the likelihood that such a firm will subsequently hire a bank on a focal stock-financed acquisition, relative to a firm that has not hired a

[4] Clients can also choose a combination of stock and cash. This choice is relatively rare, accounting for less than 5 percent of acquisitions in this sample.

bank on its prior acquisition. This reasoning leads to the following hypothesis:

> *Hypothesis 1a: Hiring a bank on a prior acquisition increases the likelihood that a firm will hire a bank on a focal stock-financed acquisition.*

But, to reap the benefits of its influence, a focal bank must persuade its client to hire *it* on future stock-financed acquisitions. As discussed, focal engagements are opportunities for banks to make relationship specific investments that increase clients' switching costs. This may include personal and trusting relationships between bankers and counterparts at clients that enable bankers to gather confidential knowledge about the nature, prospects, and value of their client's activities. Thus, a stronger test of bank influence concerns whether a bank that works on a client's acquisition will persuade that client to hire it on a focal stock-financed acquisition, as follows:

> *Hypothesis 1b: Hiring a bank on a prior acquisition increases the likelihood that a firm will hire that bank on a focal stock-financed acquisition.*

A further argument is that banks have greater access to a firm when they advise on a greater number of that firm's acquisitions. A 'primary' bank often serves as a firm's principal advisor, receiving monthly retainers for attendant services and advising on a series of clients' acquisitions (Baker, 1990). With greater client interaction (Eccles and Crane, 1988), banks have more opportunity to alert clients to the importance and requirements of stock financing. The more general argument is that as banks work on more of a firm's acquisitions, they have greater access to such firm. This then increases banks' potential influence on clients. Put another way, as banks work on more of a firm's acquisitions, that firm becomes more likely to hire banks on focal stock-financed acquisitions, as follows:

> *Hypothesis 1c: The more that a firm hires a bank on its prior acquisitions, the more likely it becomes to hire a bank on a focal stock-financed acquisition.*

Until now, banks have been portrayed as influential. A more balanced approach recognizes the conditions in which such influence is less likely to prevail.

In particular, the extent to which banks influence clients on an acquisition is likely to be moderated by the performance of that acquisition. While there are many indicators of such performance, one is the wealth that investors expect the acquisition to generate. This translates into the extent to which investors bid the acquiror's share price up or down when the deal is announced, a measure that top managers seek to influence (Westphal and Zajac, 1998).

If banks have worked on a successful acquisition, as measured by announcement returns, client managers may overattribute such outcome to banks' expertise (French and Raven, 1968; Kelley, 1971). With this success, such managers are also less likely to search for new acquisition routines, including changing or avoiding banks (Levitt and March, 1988). By the same token, an unsuccessful acquisition may be overattributed to the advising bank, prompting the search for different routines such as not to hire a bank. For these reasons, more successful acquisitions on which a firm hires a bank increase the likelihood that such firm will continue to use a bank on stock-financed acquisitions:

> *Hypothesis 2: Hiring a bank on a more successful prior acquisition increases the likelihood that a firm will hire a bank on a focal stock-financed acquisition.*

Other conditions that mitigate bank influence include those where clients have greater expertise about stock financing. As clients undertake stock-financed acquisitions, they learn about them, even if spuriously (Hayward, 2002). Learning may confer greater ability to, say, evaluate banks' work and biases; and undertake the work independently of banks. Further, as firms undertake stock-financed acquisitions without banks, they increase the likelihood that the learning accrues to them as opposed to their advisors. This leads to the following:

> *Hypothesis 3: The likelihood that banks' prior work with a client leads that client to hire banks on stock-financed acquisitions is lower for firms with greater experience at making stock-financed acquisitions without banks.*

The foregoing addressed the manner in which banks influence their clients. Another matter is

whether such influence benefits clients. On the one hand, bank advice may be instrumental in successful stock-financed acquisitions. On the other hand, banks' expertise may be insufficient to overcome the complexities of attaining such performance.

Banks, stock financing, and acquisition performance

To return to the earlier quotes, prominent bankers often represent stock-financed acquisitions as 'affordable' and salutary. Further, in the process of persuading clients to hire them, bankers purport that their expertise can produce superior performance from stock-financed acquisitions. Yet, evidence of losses from such acquisitions suggests that such representations may be exaggerated and misleading (Servaes and Zenner, 1996). Exaggerated representations are a common means by which actors, across a broad array of contexts, enhance their products and services (e.g., Cialdini, 1993; Liden and Mitchell, 1988). Further, those representations become more credible and salient as issuers hold more pertinent expertise relative to recipients (Cialdini, Braver, and Lewis, 1974; Pfeffer and Cialdini, 1998).

In the present context, the more that clients use banks, the less skilled clients become at evaluating banks' expertise. To further borrow from an earlier argument, these clients become less able to evaluate banks' contributions to those acquisitions. Clients then risk underestimating the costs of stock-financed acquisitions and overestimating banks' ability to manage them. This then reduces their ability to extract superior performance from stock-financed acquisitions. Conversely, as clients undertake stock-financed acquisitions without banks, they can better evaluate how and what banks may contribute to stock-financed acquisitions. Put another way:

> *Hypothesis 4: The more that clients previously undertake stock-financed acquisitions without banks, the greater the performance of hiring banks on stock-financed acquisitions.*

I now turn to the sample and methods that are used to test the above hypotheses.

SAMPLE AND METHODS

This study predicts the influence of banks and other determinants of firms' acquisition financing and performance. The sample consists of all publicly disclosed acquisitions during the years 1985 through 1995 for 120 U.S.-based companies. The companies were the largest, in terms of market capitalization (as reported by *Fortune* magazine in 1990), in six randomly chosen industries: drug and medical supplies, food processing, oil and gas refining and production, paper and forest products, regional banking, and telecommunications services. Regional banking firms are depository institutions rather than investment banks. Diverse industries were chosen to establish more generalizable results.

This study requires a comprehensive list of firm acquisitions and the choices made on those acquisitions. I used Morgan Stanley's database to develop these histories. Morgan Stanley uses Securities Data Corporation's data and updates it with intelligence that its analysts collect. The sample consists of acquisitions of foreign and domestic targets; public and private targets; and assets of these firms. It provides comprehensive data on firm acquisition histories, including that on the acquisition's announcement date, financing, value, advisors, and other material terms and conditions.

The approach here is to predict the focal acquisition choices and performance of firms during the period from 1990 to 1995. This approach netted a sample of 404 focal acquisitions. Of these acquisitions, 58 were in drug and medical supplies, 55 were in food processing, 25 were in oil and gas production and refining, 22 were in paper and forest products, 158 were in regional banking, and 86 were in telecommunications services. Because the independent variables require understanding of bank involvement on prior acquisitions, I also collected data on all the variables from 1985 through 1990. This involved a further 342 acquisitions. This forms a pooled sample of time series data. The two dependent variables, the use of banks and stock on a focal acquisition and acquisition performance, are measured as follows.

Dependent variables

Bank and stock financing is one of four possible outcomes that govern choices about the medium of financing and acquisition advisors. The others are

bank and cash financing; no bank and stock; and no bank and cash. I code outcomes that involve a combination of stock and cash as stock. This latter outcome concerned less than 5 percent of all acquisitions in this sample. Because the acquiring firm uses stock in these cases, the outcome is suited to bank expertise. Later, I describe the strategy of using multinomial logit models to predict firms' choice of bank and stock financing (see Figure 1). Focal bank and stock financing, the dependent variable used in Model 2 of Table 2, is analogous to bank and stock financing, with the exception that this variable is coded 1 when the bank on the focal acquisition is the same as that on the prior acquisition.

Acquisition performance is measured using the event-study methodology that yields cumulative abnormal returns. This approach, conventional in finance and organizational research, is outlined elsewhere (e.g., Fama *et al.*, 1969). Following this approach, I calculate a market model to estimate the expected performance of the stock price around the time of the acquisition announcement, given the performance of the market. The market model adopted here estimates the relationship between firm returns and equally weighted market returns for the 250 trading days (roughly 1 year of trading) starting from 30 days prior to the announcement of the acquisition. This 30-day 'cushion' seeks to remove the effect of takeover news that could already be incorporated in the market price of the acquiring firm. Immediate acquisition returns are the abnormal or excess returns of the acquiring firms as measured over a 5-day interval (the day of the acquisition announcement and the 2 days immediately prior to and after the announcement). The results for 1- (day of announcement), 3-, 7-, and 9-day intervals were also calculated and yielded similar results to the 5-day window as I will report. The Center for Research on Security Prices is the source of data on the excess returns.

Independent variables

I examine the influence of banks that work on all the firm's prior acquisitions through three variables. *Bank on prior acquisition* is a dummy variable coded 1 where a firm used a bank on its prior acquisition. *Focal bank on prior acquisition* is a dummy variable coded 1 where a firm used the same bank on its prior acquisition that it did on its focal acquisition. The variable *Banks on prior acquisitions* is a count of the number of times banks advised the firm on its prior acquisitions. Similar to another study, this variable is left censored in 1985 because I lacked data on bank usage prior to that date (Haunschild and Miner, 1997). When the firm only made one acquisition during the sample period (1985–90) I code this variable 0. At times, clients use multiple banks on prior acquisitions. To avoid overrepresenting any one acquisition, the maximum count on any one acquisition is 1. Company statements, including financial reports, and Securities Data Corporation are the sources of these data. Because these variables are quite correlated with banks on prior acquisitions and all banks on prior acquisitions, I enter them in separate equations for the purposes of data analysis.

Performance of prior acquisition with bank is the interaction of using a bank on a prior acquisition with the performance of that acquisition, where performance is measured by announcement returns as discussed.

Stock financing without banks is a count of those acquisitions, between January 1, 1985 and the time of the acquisition, of the times that the acquiror makes a stock-financed acquisition without banks.

Control variables

I used three sets of control variables to capture competing explanations of firms' acquisition choices and performance: the acquiror's industrial and economic context; reasons for choosing stock; and reasons for choosing banks.

Acquiror industrial and economic context

Some industries are more conducive to specific financing decisions (e.g., stock financing is much more prevalent in regional banking). Industry influences are reported in Table 2 but not in the logistic regression equations because they are specified when I control for the fixed effects of firms. Further, firms' use of stock may relate to prevailing economic conditions because, say, more adverse economic conditions are not conducive to raising and servicing debt (Martin, 1996). I control for these factors through industry (five dummies) and year (five dummies) dummy variables. Year dummy variables are reported in the logistic regression analyses.

Reasons for choosing stock

A second set of variables controls for explanations of stock financing that are prominent in the finance literature. For these variables, earnings statement, balance sheet, and shareholder data come from Compact Disclosure; stock market data, including that on price earnings ratios, come from Bloomberg; and data on the profiles of acquiring firms, including their acquisition experience, come from Morgan Stanley.

In the 'cash availability hypothesis', firms with more cash are more likely to use it for financing, perhaps wastefully (Jensen, 1986). *Acquiror cash availability* controls for this and is measured as earnings before interest depreciation and tax less interest expense less taxation expense less preferred and common stock dividends in the fiscal year prior to the announcement date of the acquisition (Martin, 1996).

In the 'investment opportunities hypothesis' acquirors with growth objectives prefer to use stock because debt requires management to pay cash flows that could otherwise be used to fund growth. *Acquiror gearing* controls for this and is measured as the acquiror's total short-term and long-term debt divided by total equity capital and reserves in the 30 days prior to the acquisition announcement. Because industry gearing ratios can vary markedly across industries, it is important to adjust these ratios for industry averages. Following Martin (1996), this is the difference between the acquiring firm's gearing ratio and the average gearing ratio for its industry based on the 4-digit Standard Industrial Classification code. Compustat was the source of these latter data.

In the 'control hypothesis', managers are reluctant to use stock if it dilutes their control and leads to outside intervention. *Acquiror management control* measures this as the percentage firm ownership by all officers and directors 30 days before acquisition announcement.

In the 'outside monitoring hypothesis' stock-financed acquisitions are less likely in the presence of outside monitors who watch acquiring managers (Amihud, Lev, and Travlos, 1990). *Acquiror outside monitors* controls for this and is measured as the percentage ownership of blockholder (individuals not part of the management team) and institutional shareholders in the acquiring firm.

In the acquisition program hypothesis, acquirors prefer stock vs. cash because their acquisition programs are capital intensive. *Acquiror acquisition program* controls for this and is measured as the number of acquisitions that the acquiror undertook between January 1, 1985 and the announcement date. Firms that undertook their first acquisition during the focal period (1990–95) received an experience score of 0. Compact Disclosure was the source of data for all these variables.

In the 'acquiror overvalued stock' hypothesis acquirors prefer stock over cash because they perceive that their stock is overvalued (Myers and Majluf, 1984). *Acquiror overvalued stock* controls for this with the acquiror's price earnings ratio. This is the share price of the acquiror 30 days prior to the acquisition announcement in relation to its latest full year earnings reported up to that date.

In the 'risk-sharing hypothesis', target managers know the value of their firm better than acquiring managers. Therefore, acquiring managers want target managers to share in any postacquisition reevaluation effects by having them take stock. *Relative acquisition size* controls for this because the bigger the target in relation to the acquiror, the greater the potential for such risk sharing. Relative size is the market capitalization of the acquiror at the time of acquisition announcement in relation to the final value paid for the acquisition.

There is some evidence that the choice of acquisition financing relates to the acquiror's size, say, because bigger firms have more cash flow to support cash-financed acquisitions (Travlos, 1987). *Firm sales* is the acquiring firm's sales prior to acquisition announcement. In this vein, better-performing firms may prefer stock financing because their stock is more desirable to target investors. *Firm performance* is the percentage change in total shareholder returns (share price appreciation and dividend payments) of the acquiring firm for the calendar year leading up to 30 days prior to the acquisition announcement. This variable controls for overall firm performance as opposed to a firm's acquisition performance.

Reasons for hiring banks

A third set of variables controls for competing explanations for hiring a bank. Data on the types of bids that acquirors make come from Morgan Stanley. Previous research shows that firms are more likely to use banks when they engage in three types

of more complex transactions. First, larger transactions tend to involve greater risk and these risks are controlled for with the relative size variable above. Second, foreign transactions involve complexities of dealing with foreign shareholders, including foreign exchange fluctuations. *Foreign bid* controls for this and is coded 1 where the bid is for a foreign company and 0 where the bid is for a domestic company. Third, acquisitions that diversify the firm away from its core business can also be more complex. *Similar bid* controls for the similarity of the focal acquisition to a firm's existing line of business, using a 1–4-point scale similar to Rumelt (1974). Target shareholders may be more receptive to owning shares in a business that is similar to their own. This measure derives from the following 4-point scale common in strategy research: 4 = acquired business and the firm are in the same business, sharing identical 4-digit SIC codes; 3 = acquired business and the firm share significant commonalities in their value chains or share 2-digit SIC codes; 2 = acquired business and the firm have some intangible commonalities; and 1 = acquired business and the firm are unrelated (see Rumelt, 1974). Two researchers (one is the author) coded these data independently. This coding is more straightforward when the SIC codes of the firms are provided in Compact Disclosure. When the SIC codes could not be established, business descriptions for the target business were attained from Compact Disclosure and Moodys reports. Coders disagreed on the similarity score for 28 of these acquisitions. In these cases, the coders deferred to the opinion of a third researcher. Acquisitions may also be more problematic because the acquiror engages in a hostile bid in the sense that is not supported by target firm managers (Martin and McConnell, 1991; Martin, 1996). *Tender bid* is a dummy variable, whereby 1 denotes a tender offer and 0 otherwise (Servaes and Zenner, 1996). There is also some evidence that acquirors are more likely to use banks when they purchase an independent company, or the assets thereof, rather than a public company. Detailed financial information on targets tends to be more available for public than private companies, rendering these latter transactions more complex (Servaes and Zenner, 1996: 702). *Private bid* for a private company or assets of a public company are coded 1 and public companies are coded 0.

I now turn to issues involved with estimating the models that use the above data.

Estimation issues

A potentially confounding issue with this study is the joint outcome associated with the dependent variable. Namely, do the explanatory variables explain why firms use stock or why they use banks or both? To address this possible heterogeneity, I use multinomial logistic regression to test whether firms select the joint outcome, stock, and banks (mlogit procedure in Stata). This procedure 'performs maximum likelihood estimation of models with discrete dependent variables; and is appropriate when the dependent variable takes on more than two outcomes and the outcomes have no natural ordering' (Stata, 1999: 399). This involves estimating simultaneous logistic regression models to predict whether the firm used banks and stock as opposed to the other categories.

Another potentially confounding issue is that some firms in the sample contribute multiple observations, possibly creating nonindependence among the multiple acquisitions of any one firm. I address this issue in three ways. First, I use firm dummies in the multinomial logistic regression analysis. In a second procedure I removed firm dummies. I then controlled for the fixed effects of firms in the logistic regression equations, using the Chamberlain (1980) conditional logistic regression procedure (clogit in Stata). This procedure is only appropriate for 0/1 dependent variables. Hence, I collapsed the dependent variable so that 1 represents cases when firms use banks and stock and 0 otherwise. Results from this analysis are consistent with those reported for the multinomial logistic regression analysis. Third, following Haunschild and Miner (1997), I performed another check (not shown in the later tables). Namely, the analysis is conducted for a sample of all acquisitions done by multiple-acquisition firms and for another sample involving only one randomly selected acquisition for such firms. When I use this latter sample, the effect of each of the bank variables declines, but not significantly.

A related source of nonindependence is the relatively large number of acquisitions in this sample undertaken by regional banking firms. Regional banks strongly favor stock financing; they have greater in-house finance expertise; and they are far less likely to hire banks. To analyze regional banks as a separate group, I perform the multinomial logistic regressions for regional and nonregional banks (see Table 3).

Bank influence is most evident when clients shift from cash to stock deals, as opposed to whether they persist with stock deals. To test for these two dynamics, I perform supplementary analysis that splits the sample according to clients that use cash and those that use stock. I report the main findings of these supplementary analyses later in this article.

Acquisition performance is a continuous variable and so I use ordinary least squares to analyze its determinants (see Tables 4 and 5). To control for fixed firm effects in this analysis, I deviate observations from the mean firm level using xtreg in Stata. There were no missing data in the multinomial logistic regression analysis, yielding a sample of 404 acquisitions. In predicting acquisition performance, I also eliminate very small transactions, the effects of which are masked by the daily gyrations of the stock market. This involved 112 acquisitions that were purchased for a consideration of less than 2 percent of the market capitalization (upon announcement of the bid) of the acquiring firm. From this group, I was left with 84 stock-financed acquisitions that involved banks; and for which I had acquisition performance data.

Nineteen firms contributed multiple acquisitions to this sample; and I controlled for these fixed firm effects by deviating observations from mean levels for these firms.

RESULTS

Background

Tables 1 and 2 provide background data on the variables used in this sample. Table 2 describes firm choices of advisor and financing for each of the industries in this sample. As this table shows, firms used banks on roughly 50 percent of all their acquisitions; and they used stock on 56 percent of all their acquisitions. These outcomes vary by industry. In particular, regional banks were least likely to use banks, hiring them on 36 percent of deals; and they were also most likely to use stock, making that choice on nearly 80 percent of their deals. To contrast such choices, food-processing firms used banks on 43 percent and stock on 25 percent of their deals. Table 2 also shows the popularity of focal acquisition choices that involve (a) bank and stock, (b) bank and cash, (c) no-bank and stock and (d) no-bank and cash. Taking all the acquisitions from 1990 to 1995, the decision to use bank and stock was the most common choice, accounting for 29 percent of all acquisitions. The choice of bank and cash was the least popular, accounting for 20 percent of all acquisitions.

Banks and acquisition financing

Data used for this study permit analysis of at least four forms of bank influence on clients' practices: banks on focal acquisitions, banks on a firm's prior acquisition, a focal bank on a firm's prior acquisition, and banks on all of a firm's prior acquisitions.

One approach to assessing bank influence is to examine whether banks that work on a client's focal acquisition are associated with the choice of stock financing. In separate analysis (not shown), I examine this potential effect. Odds ratio analysis shows that acquirors that hire banks are more than twice as likely to use stock on focal acquisitions, relative to firms that do not hire banks. This provides preliminary evidence that banks influence clients on their present work. But there is a confounding causality issue: Do clients ask banks to recommend financing or do they get banks to help implement a method that they have already chosen? To further investigate such causality, researchers for this study conducted interviews with the Chief Financial Officer or Head of Business Development at eight active acquirors who completed 72 acquisitions between 1990 and 1997.[5] These firms used banks to advise them on 48 of these acquisitions. Through direct interviews, these officers were asked whether banks advised them on the choice of financing. These results were inconclusive. Some firms reported that banks were always engaged to help make such choice and others reported that banks were engaged only to help implement a mode of financing.

Because one's power is a function of one's prior action, it is more theoretically compelling to examine the effects of banks that work on their clients' prior acquisitions (Giddens, 1984; Pfeffer, 1981). Banks gain fees on stock-financed acquisitions either when clients choose stock and then hire a bank or when banks help clients choose stock. Table 3 provides results of the multinomial

[5] These firms were Becton and Dickinson, Best Foods, British Petroleum, British Telecom, Merck & Co., Pepsico, Philip Morris, Smithkline Beecham.

Table 1. Descriptive statistics and correlations

		N	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
1	Bank on stock-financed acquisitions	117	0.29	0.32	1																		
2	Acquisition performance	292	−0.01	0.04	−0.02	1																	
3	Bank on prior acquisition	404	0.48	0.18	0.25	0.08	1																
4	Focal bank on prior acquisition	404	0.22	0.12	0.21	0.11	0.46	1															
5	Banks on prior acquisitions	404	2.52	0.31	0.29	−0.12	0.74	0.59	1														
6	Acquiror stock experience without banks	404	0.67	0.22	−0.16	−0.06	−0.04	−0.04	0.13	1													
7	Acquiror cash availability (ln)	404	6.74	1.38	−0.11	−0.12	−0.08	−0.07	−0.04	0.06	1												
8	Acquiror gearing (%)	404	136.25	0.93	0.14	0.01	0.00	0.00	0.03	−0.2	0.01	1											
9	Acquiror management control (%)	404	4.74	1.51	−0.08	0.04	0.03	0.03	0.02	0.09	0.13	0.09	1										
10	Acquiror outside monitors (%)	404	7.22	0.22	−0.16	0.09	0.09	0.09	−0.11	0.13	0.06	0.02	−0	1									
11	Acquiror acquisition program (#)	404	4.84	4.62	0.22	−0.11	−0.09	−0.06	0.31	0.26	0.41	0.25	0.13	−0.1	1								
12	Acquiror overvalued stock (PER)	404	17.63	3.21	0.26	−0.08	−0.08	−0.06	0.00	−0.19	−0.05	−0.13	0.01	−0.03	0.26	1							
13	Relative acquisition size (%)	404	2.38	0.56	0.15	0.02	0.02	0.01	0.03	0.01	0.09	−0.06	0.04	−0.06	0.18	0.23	1						
14	Acquiror sales (ln)	404	22.09	16.87	0.04	0.00	0.00	0.00	0.12	0.11	0.00	0.16	0.11	0.00	0.26	0.02	0.06	1					
15	Acquiror performance (%)	404	18.62	32.37	0.06	0.09	0.07	0.06	−0.02	−0.12	−0.08	0.10	0.16	−0.02	0.06	0.31	0.12	0.16	1				
16	Foreign bid (%)	404	22.43	0.41	−0.36	−0.05	−0.05	−0.04	0.12	−0.04	0.13	−0.29	0.08	0.00	0.13	0.03	0.02	0.08	−0.1	1			
17	Similar bid	404	3.17	1.01	0.01	0.14	0.13	0.11	−0.15	0.11	−0.11	0.23	0.02	0.00	−0.02	−0.06	0.04	0.07	0.08	0.09	1		
18	Tender bid	404	4.02	0.19	−0.11	−0.05	−0.04	−0.04	0.15	−0.06	−0.01	0.00	−0.03	−0.11	0.16	0.11	0.01	0.03	−0.02	0.13	0.03	1	
19	Private bid	404	18.14	4.23	−0.02	0.01	0.01	0.01	0.05	0.06	0.11	0.01	0.00	0.02	0.12	0.05	0.08	0.11	0.06	−0.03	0.2	−0.06	1

Table 2. The choice of advisor and acquisition financing by industry, 1990–95*

	Total	Bank	Stock	Bank and stock	Bank and cash	No-bank and stock	No-bank and cash
All industries (number of all acquisitions)	404	199	226	117	82	102	103
All industries (% all acquisitions)		49.26%	55.94%	28.96%	20.29%	25.25%	25.50%
Banking (regional) (number)	146	52	116	39	13	77	17
Banking (%)		35.62%	79.42%	26.71%	8.90%	52.71%	11.67%
Food Processing (number)	65	28	16	8	20	8	29
Food Processing (%)		43.08%	24.97%	12.45%	30.63%	12.52%	44.40%
Integrated Oil and Gas (number)	25	11	7	3	8	4	10
Integrated Oil and Gas (%)		44.00%	28.82%	12.58%	31.42%	16.24%	39.76%
Paper and Forest Products (number)	22	12	4	2	10	2	8
Paper and Forest Products (%)		54.55%	19.11%	10.00%	44.55%	9.11%	36.35%
Pharma. and Medical Equipment Number	58	43	34	29	14	5	10
Pharma. and Medical Equipment (%)		74.14%	59.12%	50.51%	23.63%	8.61%	17.25%
Telecommunications Services (number)	88	53	40	32	21	8	27
Telecommunications Services (%)		60.23%	45.45%	36.38%	23.85%	9.08%	30.70%

* There were 18 instances of stock and cash and these are treated as stock.

logistic regression analysis that estimates this influence. Because choices made by regional banking acquirors differed markedly from other acquirors, the former is treated as a separate category in the analysis.

Table 3 provides support for the hypothesis that banks use work to get clients to hire them on subsequent stock-financed acquisitions. This result holds when (a) any bank works on a firm's prior acquisition, (b) the focal bank works on a firm's prior acquisitions, and (c) banks work on more of a firm's prior acquisitions. It holds for both samples of acquirors, with the exception that regional banking acquirors that hired a focal bank on a prior acquisition were not significantly more likely to hire that bank on a subsequent stock-financed acquisition. This effect was strongest when banks have greater access to clients, namely by working on more of their acquisitions.

Hypothesis 2 predicted that hiring a bank on a more successful prior acquisition would further increase the likelihood that firms would hire a bank on a focal stock-financed acquisition. This hypothesis was also supported for both samples, providing evidence that more successful engagements increase professional firms' influence.

Hypothesis 3 predicted that, as firms become more experienced at making stock-financed acquisitions without banks, they become less likely to hire banks on focal stock-financed acquisitions. As Table 3 shows, there is no support for this hypothesis in either sample. That is, firms' experience with stock-financed acquisitions does not significantly affect the likelihood that they will avoid this form of bank influence.

Taken together, these results support the reasoning that banks' prior work helps them to steer clients towards hiring them on subsequent stock-financed acquisitions, and provide evidence of when that influence is more pronounced. Having discussed the effects of banks on firms' choice of acquisition routines, the following examine the effects of banks on acquisition performance.

Banks and acquisition performance

Table 4 provides mean cumulative abnormal returns for acquisitions with different choices of advisor and financing. Table 4 shows that firms that hire banks on stock-financed acquisitions experienced lower acquisitions performance than firms that adopt any of the other choices shown in Figure 1. This corroborates earlier evidence of a similar result (Servaes and Zenner, 1996).

According to Hypothesis 4, client performance on such acquisitions increases when clients have previously made stock-financed acquisitions without banks. To test for this, I regressed this variable on acquisition performance using ordinary least squares estimation. Results from this analysis are shown in Table 5.

Table 5 shows some weak support for Hypothesis 4: Focal acquisition performance was higher for firms that had previously made stock-financed acquisitions without banks ($p < 0.10$).

Table 3. Multinomial logistic regression of bank influence on firms' acquisition choices

	Non-banking firms				Regional banking firms			
	Controls	Model 1	Model 2	Model 3	Controls	Model 1	Model 2	Model 3
Bank on prior acquisition (H1a)		0.176***				0.094**		
		0.038				0.038		
Focal bank on prior acquisition (H1b)			0.128**				0.086	
			0.052				0.049	
Banks on prior acquisitions (H1c)				0.225***				0.076***
				0.032				0.033
Banks on successful prior acquisitions (H2)				0.347***				0.363**
				0.128				0.147
Stock financing without banks (H3)				−0.178				−0.423
				0.229				0.377
Acquiror cash availability (ln)	−0.656	−0.621	−0.594	−0.789	−0.023	−0.038	−0.037	−0.033
	0.343	0.351	0.366	0.399	0.128	0.133	0.178	0.137
Acquiror gearing	−0.043**	−0.044	−0.037	−0.045**	−0.010	−0.017	−0.018	−0.028
	0.021	0.021	0.028	0.022	0.333	0.331	0.289	0.321
Acquiror management control	−0.365**	−0.388	−0.344	−0.371**	−0.226	−0.178**	−0.138	−0.212**
	0.201	0.244	0.282	0.212	0.086	0.091	0.112	0.108
Acquiror outside monitors	−1.172***	1.154**	−1.322	−1.174**	−0.932	−0.897	−0.841	−0.883
	0.439	0.484	0.451	0.481	0.630	0.784	0.784	0.780
Acquiror acquisition program	0.506***	0.588***	0.521***	0.526***	0.321**	0.289	0.264	0.397***
	0.154	0.177	0.166	0.162	0.134	0.178	0.274	0.124
Acquiror overvalued stock	0.143**	0.162**	0.155**	0.151**	0.114**	0.17894**	0.128	0.094**
	0.062	0.074	0.077	0.063	0.049	0.078	0.098	0.058
Relative acquisition size	1.861***	1.282***	1.112***	1.899***	1.430***	1.978***	1.861***	1.780***
	0.490	0.421	0.553	0.482	0.440	0.458	0.478	0.654
Acquiror sales (ln)	−0.999	−0.877	−0.657	−1.040	−0.020	−0.017	−0.014	−0.031
	0.843	0.909	0.922	0.924	0.844	0.874	0.921	0.821
Acquiror performance	0.104***	0.113***	0.111***	0.016**	0.113**	0.1874***	0.105**	0.220***
	0.007	0.008	0.009	0.008	0.055	0.045	0.051	0.066
Prior acquisition performance	−0.311	−0.334	−0.322	−0.361	−0.197	−0.148	−0.060	−0.187
	0.281	0.306	0.331	0.412	0.280	0.278	0.318	0.222
Foreign bid	−2.043***	−2.859***	−2.654***	−2.654***	N.M.	N.M.	N.M.	N.M.
	0.792	0.841	0.891	0.833				
Similar bid	−2.871**	−2.411	−2.188	−2.925**	−1.878***	−1.784***	−1.784***	−1.789***
	1.273	1.317	1.677	1.281	0.340	0.478	0.542	0.510
Tender bid	−0.022**	−0.0578***	−0.075***	−0.045**	N.M.	N.M.	N.M.	N.M.
	0.004	0.008	0.009	0.010				
N	258.000	258.000	258.000	258.000	146.000	146.000	146.000	146.000
Chi-squared	50.248***	51.389***	51.809***	53.421***	33.332***	33.789***	33.841***	34.789***

** $p < 0.05$; *** $p < 0.01$

N.M., not meaningful.

Dependent variable: likelihood of using bank and stock on focal acquisition (choice 1, Figure 1).

Models reflect different hypotheses regarding bank influence. Coefficients with standard errors reported beneath them.

Year dummies are included, but coefficients are not reported.

Table 4. Mean cumulative excess returns (%) by choice of acquisition routine on focal acquisition

Interval (days)	Bank and stock	Bank and cash	No-bank and stock	No-bank and cash
−1 to 0	−2.12***	0.41	−1.19**	1.03*
−5 to +5	−1.92***	0.45	−1.21**	1.02*
−5 to +10	−1.84**	0.39	−1.08**	1.07*
−5 to +20	−1.83**	0.36	−1.00**	1.08*
N	84	61	72	75

* $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$
Two-tailed test of whether the excess returns significantly differ from 0.

Table 5. Determinants of acquisition performance

	Controls	Model
Intercept	−0.016***	−0.014***
	0.004	0.003
Acquiror stock experience without banks (H5)		0.072**
		0.029
Acquiror cash availability (ln)	−0.332***	−0.321***
	0.082	0.092
Acquiror gearing	−0.004	−0.005
	0.012	0.013
Acquiror management control	0.025	0.022
	0.014	0.018
Acquiror outside monitors	0.023**	0.022**
	0.009	0.012
Acquiror acquisition program	0.023**	0.022**
	0.009	0.012
Acquiror overvalued stock	−0.226**	−0.221**
	0.012	0.019
Relative acquisition size	−0.003	0.000
	0.010	0.010
Acquiror sales (ln)	−0.007	−0.007
	0.021	0.032
Acquiror performance	0.000	0.000
	0.000	0.000
Foreign bid	0.005	0.005
	0.007	0.007
Similar bid	0.014***	0.015***
	0.004	0.004
Tender bid	−0.031**	−0.034**
	0.016	0.013
N	84	84
Adjusted R^2	0.178***	0.182***

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$
Dependent variable: performance of stock financed acquisitions with banks.
Model 1: control variables only.
Coefficients with standard errors reported beneath them.
Year dummies are included but not reported.

Taken together, these data provide further evidence that clients that hire banks on stock-financed acquisitions experience lower acquisition performance (Servaes and Zenner, 1996). Yet, the more that clients undertake such acquisitions without banks, the greater such performance.

Control variables

These results show that bank influence is one of many determinants of the above outcomes. Nonregional banks were more likely to choose stock and banks when they had lower debt/equity ratios ($z < 0.05$), weaker management control ($z < 0.01$), less outside monitoring ($z < 0.05$), greater acquisition experience ($z < 0.01$), higher price earnings ratios ($z < 0.05$), and stronger recent firm performance ($z < 0.05$) Further, these firms were much less likely to adopt that choice when the target was relatively small, foreign, and similar to the acquiror's business. Tender offers tended to be for cash and so reduced the likelihood of using both banks and stock. These results were generally consistent with those found for regional banks. Some notable exceptions were that regional banks almost invariably avoided foreign and tender bids and so results for those coefficients were not meaningful. Further, acquiror management control and outside monitoring at regional banks did not significantly relate to the choice of banks and stock.

Taken together, these results suggest that the choice of banks and stock is influenced by a number of complex factors and bank influence is only one of them. Odds ratio analysis (not shown) showed that the relative size of the acquisition and the domestic or foreign locations of the target are more important predictors of the choice of stock and banks than bank work on the firm's prior acquisitions.

DISCUSSION

Contribution to organizational theory

Evidence from this article informs the role of professional firms in diffusing organizational practices. Results here are consistent with the hypotheses that professional firms influence their clients by getting them to attend to complex problems that utilize professional expertise. Like other decision-makers, professionals gravitate towards problems that they can solve (Dearborn and Simon, 1958;

March and Simon, 1958). Just as firms' strategies can relate to the backgrounds of executives who initiate them, they can also relate to the expertise of influential advisors (Bantel and Jackson, 1989; Fligstein, 1990).

That is, as managers defer to professional advice, their firms' decisions become more representative of professional biases. By leading clients towards complex decisions that apply professional expertise, professional firms gain greater control over such decisions. Client engagements are opportunities for professional firms to demonstrate and refine this expertise and lobby for more work. In the process of this lobbying, professional firms may purport that they can deliver superior performance from difficult choices, even if such performance is just an illusion. If clients accept such representations, they risk overestimating the efficacy of professional expertise and underestimating the difficulty of extracting gains from such choices. Together, these dynamics confound the relationship between managerial backgrounds and strategic outcomes. Thus, research on top managers and their decisions also requires careful attention to the role of professional advisors on those decisions.

This reasoning also informs institutional theory for which 'power and interests have been slighted topics' (Davis and Powell, 1992: 49). Professional firms are not simply forums for endorsing clients and protecting their managers from poor decisions (Meyer and Rowan, 1977). Rather, professional firms actively seek boundary control over clients by leading clients towards some practices and not others. This study shows that banks are more likely to diffuse stock rather than cash-financed acquisitions through interorganizational networks. The broader point is that professional firms are not neutral conduits for diffusing practices across those networks. Rather, the nature of professional expertise predicts the practices that professional firms imitate and institutionalize.

Evidence here also informs the assertion that professional norms may be so strong as to fail to 'increase organizational efficiency' (DiMaggio and Powell, 1983: 262). One mechanism of such failure is that professional firms ratify and ossify managers' deceptive or symbolic actions (Westphal and Zajac, 1998). Today, auditing firms are particularly susceptible to such a charge. Another less explored mechanism arises when professional firms assume greater control over client decisions, and so lead clients towards complex choices with problematic outcomes. At times, banks initiate and promote abstract and arcane financing choices that feature derivatives that are often housed in 'off-balance sheet partnerships' that have damaged clients.

Contribution to the literature on banks and professional firms

Findings here point to an intriguing puzzle: Why would professional firms recommend practices that damage their clients' performance? This seems like an unsustainable practice because clients will eventually recognize these effects and shun banks. Supporting this view, clients are leaving banks in increasing numbers: In spite of the boom acquisitions in the 1990s, total bank fees from acquiring firms have hardly grown since 1990. Other acquiring firms may fail to link (a) banks to stock financing; and (b) stock financing to adverse acquisition performance. This first relationship is difficult to discern because banks neither overwhelmingly nor indiscriminately favor stock. In this sample, firms that hired banks used stock on 59 percent of their acquisitions. This second relationship is also difficult to unpack because acquisition performance relates to the complex interplay of factors that mystify professional firms' contribution. While I am speculating, clients may be slow to identify, and question bankers' predisposition for stock financing.

For their part, professional firms face a bind. On the one hand, if such firms make simple and transparent recommendations, their clients may conclude that they are redundant. On the other hand, if professional firms recommend more complex choices, they expose their clients to the performance implications of such complexity. Evidence here and elsewhere suggests that professional expertise is often insufficient to ensure superior performance from those difficult choices (Servaes and Zenner, 1996). If clients reach those conclusions, they will think twice before allowing banks to persuade them to make such choice.

More generally, clients face the challenge of forging effective relationships with professional firms. On the one hand, professional firms are potentially valuable sources of knowledge and expertise, particularly for newcomers to a practice. Hiring a professional firm that is experienced with that practice can help clients reduce the costs of trial-and-error learning (Bandura, 1977). On

the other hand, professional firms seem reluctant to share their expertise with clients. Part of the problem may be that professional firms are not fully accountable for the effects of their advice. According to the President of one experienced U.S. acquiror, 'I don't ever want to live with someone else's deal. My biggest frustration with bankers and lawyers is the fact that they don't have to live with their results' (McConville, 1996: 51). Another issue is that as clients forge co-dependent relationships with their professional advisors, they lose the ability to evaluate the latter's work.

AT&T's acquisitions from the mid 1980s highlight how a firm may unduly rely on stock-financed acquisitions. Between 1985 and 1995, the firm made 12 major acquisitions. On each acquisition, the firm used an advisor to help it complete the deal. While Morgan Stanley was the firm's primary bank, it also used Goldman Sachs and Morgan Grenfell. Of the firm's nine domestic acquisitions, seven were completed with stock or a combination of stock and cash. Press reports describe the close interaction between senior firm managers and their Morgan Stanley bankers (*The Economist*, 1996). During that period, Morgan Stanley frequently advised AT&T on acquisition pricing, financing, and negotiating. Despite these efforts, AT&T's acquisitions, particularly the 1991 stock-financed acquisition of NCR, destroyed considerable shareholder value. Various factors can account for this performance (including a flawed strategy and faulty implementation), including that the firm's bankers and executives overestimated their ability to extract gains (*The Economist*, 1996). While speculative, AT&T may have developed a co-dependent relationship with Morgan Stanley that affected the firm's ability to learn from acquisition experience. As evidence, the firm's CEO attributed its disastrous acquisition of NCR to factors outside management's control, including that acquired executives did not try hard enough (*The Economist*, 1996).

Contribution to the finance literature

Why do firms make stock-financed acquisitions given the strong evidence that those acquisitions result in inferior performance?

There are logical and empirical grounds for questioning three prominent explanations for this puzzle. According to the free cash flow hypothesis, firms with excess cash make wasteful acquisitions (Jensen, 1986). While Martin (1996) reports that greater firm cash flow increases the likelihood that firms will use cash-financed acquisitions, I did not find this result. Further, for this hypothesis to be valid, cash-financed acquisitions would have to underperform stock-financed ones. Second, according to the acquiror investment opportunity hypothesis, acquirors with valuable growth opportunities prefer stock because it lets them conserve cash that would otherwise be used to service the debt. Yet, if these opportunities were valuable, that value should translate into better-performing stock-financed acquisitions. Instead, results here and elsewhere do not show a significant relationship between the acquiror's debt-to-equity ratio and its acquisition financing choice (e.g., Martin, 1996; Myers and Majluf, 1984). Third, according to the risk-sharing hypothesis, target managers know the value of their firm better than acquiring managers. Therefore, acquiring managers want target managers to share in any postacquisition reevaluation effects by having them take stock. If this hypothesis were valid, large cash-financed acquisitions would underperform large stock-financed ones. While evidence here suggests that bigger acquisitions do increase the likelihood of stock financing, such acquisitions are also associated with lower performance.

Other explanations seem more logically and empirically plausible. In the acquisition program hypothesis, managers use stock-financed acquisitions to undertake detrimental acquisitions. Here, acquiring managers gather unsustainable momentum to do more acquisitions. This pattern has been systematically found at Beatrice and Cooper Industries, amongst other firms (Baker, 1992; Kaplan, Mitchell, and Wruck, 1996). This hypothesis is also consistent with evidence here that greater acquisition experience lowers the performance of stock-financed acquisitions that involve banks. Another plausible explanation is that acquiring managers use stock financing because they believe that their company's prospects will dim and its share price will drop (Franks, Harris, and Titman, 1991; Myers and Majluf, 1984). Stock-financed acquisitions signal such expectations. Investors then mark down the firm's share price upon learning about the stock-financed acquisition. While plausible, this hypothesis is at odds with theory and evidence that acquiring managers generally exaggerate their own abilities and so their firm's prospects (Hayward and Hambrick, 1997). In the

outside control hypothesis, questionable acquiring manager decision-making is less likely when institutional and block shareholders and outside directors closely monitor acquiring managers. Evidence here and elsewhere suggests that the greater this monitoring, the less likely firms are to make stock-financed acquisitions (Amihud *et al.*, 1990; Martin, 1996; Travlos, 1987). Finally, in the control hypothesis, managers with greater personal ownership in their firm are less likely to engage in stock-financed acquisitions because that damages their investments. Consistent with other studies, I found that greater management ownership reduced the likelihood that firms would use stock and banks, at least for the sample of nonregional banking firms. The relationship that I found is the linear one reported by Amihud *et al.* (1990), rather than the nonlinear one reported by Martin (1996).

Another perspective is that stock financing allows finance professionals to apply their abstract knowledge and this enables them to gain greater influence over the acquisition process (Abbott, 1988; Pfeffer, 1981). This reasoning reflects evidence that acquisitions are not efficient market outcomes that result from the input of a large number of buyers and sellers (Hayward and Hambrick, 1997). Rather, they reflect the preferences and biases of a cadre of acquiring firm executives and their advisors who decide what and how to acquire (Cyert and March, 1963; Dearborn and Simon, 1958; March and Simon, 1958). Just as top managers' biases surface in their strategic decisions, bank biases surface in their clients' decisions (Abbott, 1988; Eccles and Crane, 1988). Further, as banks become more influential in their client's acquiring decisions, these biases become more pronounced. Even after controlling for the many other factors that affect firms' choice of stock and banks, banks' work on clients' acquisitions increases the likelihood that clients will hire banks on their subsequent acquisitions. Such outcome holds under a number of conditions that characterize clients' relationships with banks.

Taken together, these data help sketch a profile of firms that make value-destroying stock-financed acquisitions. Overall, these are aggressive acquirors that have been highly exposed to banks on their prior acquisitions. Their managers pursue rapid growth that attracts high-price earnings ratios that foster stock-financed acquisitions. Finally, such managers do not face close monitoring by external shareholders and outside directors. It is important to emphasize that this profile emerged during the buoyant equity markets experienced for much of this sample period, and may not hold during downswings in equity market cycles.

Different explanations for present results

Other factors could explain these results, including that they reflect client inertia or momentum and not bank influence (e.g., Amburgey and Miner, 1992). Namely, clients have preexisting preferences for stock and banks and use banks to ratify those preferences (Pfeffer, 1981). Yet, I found a significant and negative relationship between (a) when firms hire banks on prior cash-financed acquisitions and (b) use banks on subsequent stock-financed acquisitions. More plausible is that professional advisors reinforce inertia when clients have already arrived at practices that professionals favor. Another explanation is a self-selection bias in which weaker firms that make worse decisions hire banks. But, I found no significant relationship in this study between a client's overall performance and the likelihood that it would use stock and banks. Further research could examine how other indicators of the quality of the acquiring firm's management relate to the choice of banks and stock.

This research has closely examined the implications of professional firms' expertise for their actions. Further research could evaluate the full effects of professional firms on clients' learning about strategic decisions. In particular, the extent to which clients learn from their experience is likely to relate to who performed that work, the client or its advisor. The louder call is for systematic research on how the relationship between a firm and its advisors affects that firm's outcomes, including its performance.

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