NEW VENTURE GROWING PAINS: WHEN BEING ACQUIRED IS AN APPROPRIATE REMEDY

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Abstract

Our empirical research explores acquisitions of small entrepreneurial firms with a focus on the entrepreneurial management team (EMT) of the target firm. Utilizing the theoretical foundations of Resource Based View and Contract Theory we explore the dynamics of post acquisition performance of the target firm and the retention of the EMT. While controlling for firm size, type of purchase, ownership of target firm and industry dynamics, our results of a questionnaire survey of acquiring firms’ top managers suggest that transfer or development of the implicit contract with the target firms’ EMT positively affect both retention and performance.
The entrepreneurial management team (EMT) of a firm targeted for acquisition can be vital to enhancing post-acquisition performance as their appears to be a direct link between the performance of entrepreneurial firms and the EMT (Hmieleski, and Ensley, 2007). The EMT is in a position to contribute to the sustainable value of the new entity due to their understanding of, for example, the idiosyncratic manipulation, acquisition, disposition and development of internal assets. Their intimacy with the market, competitors, industry, and internal firm competencies has the potential to influence the future value of the firm. Consequently, acquirers may only capture the full value of the firm by securing the continuing services of the EMT. As such, from a resource based view (RBV) perspective (Barney, 1991), the EMT is a significant resource that contributed to the firm being a takeover target in the first instance as the role of human capital is critical to entrepreneurship (Wright, Hmieleski, Siegel and Ensley, 2007). Further, the departure of any members of the EMT could negatively affect the competitive benefits of such a resource and heighten the level of disruption and uncertainty in the firm post-acquisition (Cannella and Hambrick, 1993; Hambrick and Cannella, 1993; Krishnan, et. al., 1997; Singh and Zollo, 1998).

Contemporary business practice requires that EMT members are contractually bound by agreements that typically set out the explicit expectations of both parties i.e., an explicit contract. Along with what is explicit in the contractual arrangement is what is implied by this relationship. This implicit contract, we suggest, plays an important understudied role during the firm acquisition process. In this research, therefore, we address this gap in the literature by focusing our lens on implicit contracts between the EMT and the acquiring firm.

This research makes three identifiable contributions to the literature. First, we extend theory by exploring the role of implicit contracts in a previously unexplored context. This is important as scholars suggest that the implicit portion of the contract has greater impact between the parties than the explicit portion (e.g., Lusch and Brown, 1996). Second, drawing on RBV, implicit contracts idiosyncratic to a successful EMT are part of the rare, non-substitutable, inimitable, and valuable resources that contribute to the pre-acquisition firm’s sustainable competitive advantage (Barney, 1991). Significantly, being implicit, these contracts are difficult to quantify intangible resources, which have been largely overlooked in the extant entrepreneurship and acquisition literature. Finally, that entrepreneurship is a multi-faceted hybrid discipline developed from various social sciences allows us in this paper to draw from theories developed in the academic discipline of law to explain the role of implicit contracts post acquisition. Specifically, using theory fundamental to contract law we examine the development of implicit contracts and how these evolve between the target firm’s EMT and the acquiring firm.

The paper proceeds as follows. In the next section we introduce an overview of the stream of contract law literature around which we frame our argument. We then relate this to our acquisition firm context and distill two hypotheses. Our methodology is then outlined and results tabled. These results are discussed and the implications for theory and practice are canvassed.

Contract Theory
McNeil (1978) classifies the nature of contracts from three theoretical perspectives: classical, neoclassical, and relational. The classical perspective on contracts emphasizes the exchange as being transactional and separate from all past and future relations. The parties themselves are irrelevant to the transaction; the subject of exchange is short-term, specific and limited to the content of the transaction at a given point in time (MacNeil, 1978). Neoclassical contract law attempts to correct for long-term contracts where it is not possible to account for all future contingencies and appropriate adaptations. Thus, this view of contracting recognizes that the world is complex, agreements are incomplete, and that some contracts will never be reached unless both parties have confidence in the settlement process. Though neoclassical contract law attempts to include the relationship portion by introducing the notion of long-term contractual relations with specified planning and the need for flexibility (MacNeil 1978; 1981), both classical and neoclassical contract law are not sufficient to explain ongoing exchange in complex relationships in societies because they fail to take into consideration the relational component present, to differing degrees, in all exchanges (MacNeil, 1985). Clearly these conceptualizations of contracts are inadequate for the contracts between and within businesses involved in acquisitions because each fails to cover all the intricacies of individuals’ contracts.

The progressively increasing duration and complexity of contracts have resulted in the concept of discreteness to be discarded and replaced with dynamic contracts across the entire relationship of the partners. This is addressed in the relational perspective of contracting, in which the implicit aspect of contracts takes on a heightened importance and, to a degree, in the long-run overrides the ‘word of law’. Therefore, informal relationships become important to fulfilling the intent of the contract and become more important if the contract is not only transactional but also relational in nature (MacNeil, 1980). Hence, when the parties are unable to reduce important terms to well-defined obligations and ambiguities exist, an implicit contract is said to exist (Goetz and Scott, 1981). The implicit contract is distinguished by its use of norms, or patterns of accepted and expected sentiments or behavior shared by the members of an exchange system that have the force of a social obligation or of social pressure (Axelrod, 1986; Bendor and Mookerjee, 1990; Gibbs, 1981; MacNeil, 1983; Thibaut, 1968; Thibaut and Kelley, 1959). Implicit contractual norms differ greatly in their content and orientation from one setting to another (Thibaut and Kelley, 1959) and are important both from a social and an organizational viewpoint (Grundlach and Achrol, 1993).

EMT Implicit Contract Identification and Transference during Acquisition

To understand the dynamics of EMT retention in an acquisition, it is essential to understand the formal and informal linkages of the target firm’s EMT. The EMT has developed a relationship with their firm that is characterized by a formal employment agreement or explicit contract (including salary, bonuses, benefits, and the like) and an informal relationship developed over time or implicit contract (including shared values, norms, mutual expectations, and the like). The target firm’s EMT is bound to the firm through these explicit and implicit employment contracts. If the acquiring firm wishes to retain the EMT in a similar capacity as pre-acquisition, both the explicit and implicit portions of the contract need to be satisfied. Further, contracting should not be
considered a discrete transaction, rather an ongoing relationship with both explicit and implicit components (Lusch and Brown, 1996).

We suggest, therefore, that the employment agreement between the firm and the EMT is an example of a contract with a potentially large implicit component. The EMT’s duties are not specific in nature, are autonomous to a large extent, and are often non-quantifiable. Although there is an explicit employment contract, a considerable amount of the agreement between the EMT and the organization is relationship based. As the implicit portion is based upon mutual expectations and norms between the parties, this relationship must be developed amongst the parties. Mutual obligations are the essence of the employment contract defining the relationship (Rousseau, 1989). The mutual obligations are developed between the parties through their interaction, role definition, and setting of goals. These implicitly inferred obligations cause the EMT to make their contributions to an organization, even when their efforts may not be directly accountable (Nicholson and Johns, 1985). Retention of the target firm’s EMT may be challenging as mutual obligations are the essence of the employment contract defining the relationship between employee and employer (Rousseau, 1989).

As the EMT has the option to leave the firm, and is valuable enough to have the opportunities to do so, the acquiring firm will have to develop a relationship that is mutually acceptable. If the acquiring firm does not develop the implicit portion of the contract through, for example, mutual goal development, or formulation of agreeable norms acceptable to the EMT, then the EMT is more inclined to consider not staying on with the new entity. We suggest, therefore, the acquiring firm’s actions in regard to implicit contract development with the target firm’s EMT will directly affect retention of the EMT.

Hypothesis 1: There is a positive relationship between EMT retention and the ability of the acquiring firm to develop the implicit portion of the EMT contract.

Implicit Contracts and Post Acquisition Performance

The implicit portion of contracting, therefore, can be defined as a mutual understanding that exists between parties and dictates how they will interact and deal with each other. The implicit portion of the contract reflects a social consensus through reinforcement of specific behaviors and exchange patterns (Rousseau, 1985). During the ex-ante due diligence to ex post post-acquisition operations, ideally, an implicit contract between the acquirer and the target firm’s EMT needs to be developed to define the roles and the performance goals of these key managers.

Personal relationships among key individuals have played a crucial role in defining the parameters of the implicit contract (Lincoln, Gerlach, and Ahmadjian, 1996; Bradach and Eccles, 1989) in the pre-acquisition entity. Beneath the formalities of contractual agreements, multiple interpersonal relationships exist across organizational boundaries, both intra- and inter-, which facilitate the active exchange of information and a sense of trust that foster organizational cooperation (Walker, Kogut, and Shan, 1997; Gulati, 1995).

Collaboration between the EMT and the members of the new entity needs to be inclusive of implicit and explicit assumptions. Ideally, relational exchange participants on both sides will derive complex, personal, non-economic satisfaction and engage in social exchange. However, because expectations are unclear and develop over extended
time periods, the parties need to direct considerable effort toward carefully defining and measuring the items of exchange (Dwyer, Schurr and Oh, 1987).

Implicit contracts have the potential to harmonize conflict and can help to preserve relationships (MacNeil, 1974). A great deal of change in ongoing relations comes about through small-scale, day-to-day adjustments resulting from interplay amongst the participants (MacNeil, 1978). Obviously, acquiring firms have expectations of performance due to the target firm’s historical feats. However, if the implicit portion of the EMT contract does not transfer to the acquirer, performance may suffer as the previous performance of the to-be-acquired organization is based upon a successful relationship developed over time between the EMT and the firm.

Hypothesis 2: There is a positive relationship between post acquisition performance and the ability to transfer the implicit portion of the EMT contract.

Methods

Sample

Testing our hypotheses required the surveying of senior managers who had been recently involved in an acquisition and who had knowledge of post-acquisition performance. Ernst and Young Inc. provided us with their database of senior executives (n = 807) who had acquired entrepreneurial firms within the previous 1-2 years. Surveys were sent to individuals on the database with the following titles: Vice Presidents (n = 110), Senior VP (n = 23), CEOs (n = 24), CFOs (n = 25), and Director (n = 49). After eliminating those that were either no longer at that address, marked “Return to Sender”, or their office notified us they were not longer with the firm, we had 610 possible respondents. We received 102 usable responses from a cross-section of industries for a final response rate of 17%, which is consistent with similar surveys (cf., Weaver, Travino, Cochrane 1999; Hambrick, Geletkancyz, & Fredrickson, 1993).

Measures

Post Acquisition Performance: The results of acquisitions are difficult to assess accurately, both in terms of the indices used and the appropriate time span over which to judge acquisition performance (Hogan and Overmyer-Day, 1994; Lubatkin, 1983; 1987). Focusing only on financial results such as income statement ratios and balance sheet issues, means that the role of people, knowledge gained, or other intangible goals are often overlooked (Hunt, 1987; Levinson, 1970; Kitching, 1967). Prior acquisition research has focused on variables such as potential growth rate and target evaluation (Baker, Miller and Ramsperger, 1981), communication (Schweiger and Denisi, 1991; Sinetar, 1981), merger goals (Cartwright and Cooper, 1992; Kitching, 1967), organizational culture fit (Buono, Bowditch and Lewis, 1995; Marks and Mirvis 1992, 2000), and retaining the EMT (Hambrick and Cannella, 1993; Haynes and Hoag, 1974).

Three key areas of acquisition performance were examined: perceived financial acquisition performance, goal attainment, and satisfaction with employee performance. These three measures represent financial and non-financial outcomes and a comparative method is more effective in eliciting responses than asking respondents directly to provide exact numbers for acquisition performance (such as dollar amount of sales, market share, etc.) (Lau and Ngo, 2001; Tomaskovic-Devey, Leiter and Thompson,
Our scale was adapted from existing measures developed by Lau and Ngo (2001) and Cannella and Hambrick (1993). There were ten items (4 measuring financial performance, 3 measuring employee performance and 3 measuring goal attainment) with a Cronbach’s alpha of .94.

**Implicit Contract:** To measure the extent to which the implicit portion of the relationship was transferred we adapted a scale developed by Lusch and Brown (1996), which focuses on implicit contracting over roles and implicit contracting over the handling for unexpected events. Issues such as mutual understanding on how to handle unexpected events the mutual understanding of the responsibilities and roles were measured. There were 5 items in the scale which reported a Cronbach’s alpha of .86.

**EMT Retention:** To establish the extent to which the acquiring firm was able to retain the target EMT we established the proportion, and the perceived value, of the retained executives (Cannella and Hambrick, 1993). Reviewing the sheer number of executives retained does not provide a full picture. Although we argue the EMT is valuable, it is also true that there are individuals in smaller firms that may be (for example) relatives with an executive title (or similar situations), but of no value. Therefore, we explored both the number of executives retained, and whether the valuable executives were retained. Four items made up the scale with a Cronbach’s alpha of .97.

**Firm Size:** As size differences between acquiring and acquired firms may influence acquisition performance (Kusewitt, 1985) we included size as a control in our analyses. Increases in firm size add complexity due to increases in structural elaboration and the introduction of formalized systems for planning, control, and resource allocation (Quinn and Cameron, 1983). As a result, increases in firm size can create progressively stronger resistance to fundamental change (Tushman and Romanelli, 1985). There is evidence that the smaller an acquired firm relative to an acquiring firm, the greater an acquired executive’s propensity to depart (Hambrick and Cannella, 1993). Consistent with previous work in the acquisition literature, we calculated size by dividing the sales of the acquired firm before acquisition by the sales of the acquiring firm (Hambrick and Canella, 1993).

**Type of Purchase:** Our second control variable was the method by which the acquired firm was purchased. The acquiring firm has several options: they can use their cash holdings, increase their debt by borrowing, and sell more equity through shares of stock, or a combination of these. However, as our research focus is on the target firm’s EMT, their retention and value to post-acquisition performance, we are concerned with what the target firm’s receives and in what form. For example, a cash purchase may unduly enrich the target firm EMT (assuming they are stock holders) who may then wish to exit the situation while a stock purchase may encourage the target EMT to continue with the association. The type of purchase may also affect the subsequent acquisition performance due to EMT motivational issues.

**Ownership of Target Firm:** We also controlled for the ownership structure of the target firm (i.e., privately-owned, publicly-owned with dispersed stockholders, or publicly-owned with few majority stockholders). Privately-owned firms will typically also be managed by an owner who is also a member of the EMT. Purchasing a privately-owned firm may/may not suggest that the owner is either retiring or going to pursue other interests. Consistent with the RBV, the owner may only be seeking resources from the acquiring firm in which to continue and be more successful. A publicly-owned firm with
diverse investors will be managed by an EMT of experts. To establish ownership, we asked whether the acquired firm was a spin-off from another firm, privately-owned, publicly-owned firm with few majority holders, or a publicly-owned firm with dispersed ownership.

**Industry Dynamics:** Industry dynamics was controlled for by establishing munificence and dynamism. Munificence is the capability or the ability of the environment to sustain growth. Dynamism is the stability or instability and the rate or degree of environmental change (Dess and Beard, 1984). Munificence was calculated using a five-year growth in net sales for each industry (1998-2002). Using annual figures across all firms in each relevant industry, the natural logarithms were utilized in a time series approach from Standard and Poor’s Industry Surveys (11-13-2003). Time served as the independent variable. The growth measure of each was the antilog of the regression slope coefficient. The result is a smoothed measure of the average growth rate over the period. Instability reflected five year patterns of instability in the dominant industry. The measures were antilogs of the standard error of each regression slope coefficient from the growth equations described in the munificence measure.

**Response Bias and Subjectivity:** Wave analysis employing MANOVA was used to check for non-response bias examining selected scale items from each construct (Armstrong and Overton, 1977). Each of the major survey waves was counted as a separate wave, for a total of three waves. There were no significant differences between each wave indicating no evidence of non-response bias.

Key informant methodology has some significant drawbacks, that of informant bias and random error. Since our sample used key informants that occupy roles that make them knowledgeable about the issues being researched, and were able and willing to communicate with the researcher, we suggest that key informant bias is not of a major consideration (Campbell, 1955). Retrospective reports in regard to perceptions have been researched (Huber and Power, 1985; Golden, 1992) utilizing executive’s retrospective accounts to identify firm strategy (Boeker, 1989; Feser and Willard, 1990), planning processes (Eisenhardt and Bourgeois, 1988; Mintzberg, Raisinghani and Theoret, 1976; Nutt, 1987) and strategic and organizational change (Eisenhardt and Schoonhoven, 1990; Smith and Grimm, 1987). Other research suggests sole informants at high levels such as CEO may actually increase the validity, or confidence therein, in their report (Sharfman, 1998). More recent research suggests that retrospective reports are accurate and an effective technique for management research (Golden, 1992).

**Results**

Table 1 presents the means, standard deviations and Pearson correlations for our variables. The results of the tests of our hypotheses are presented in Tables 2 and Table 3. To examine all the hypotheses, we used hierarchal linear regression.

Hypothesis 1 posited that EMT retention would be positively related with the ability of the acquiring firm to develop the implicit portion of the EMT contract. Testing for this, step one of the inclusion of the control variables (Size, Industry Dynamics, Type of Purchase and Ownership of Target Firm), was not significant with an F-value of 1.050 (see Table 2). However, the regression indicated that the addition of Implicit Contract to the control variables proved to be significant at $p < .001$ with an F-value of 3.045. The R-squared was .276 and Beta was .449. Therefore, $H_1$ is supported.
Hypothesis 2 posited that post acquisition performance would be positively related with the ability to transfer the implicit portion of the EMT contract. Model 1, which is the regression with the control variables, was not significant an F-value of .871 (see Table 3). The regression indicated that the addition of the Implicit Contract variable to the control variables proved to be significant at p < .001 with an F-value of 4.524. The R-square was .361. Review of the coefficients suggests that the variable is significant at p < .001 with Beta at .567. Therefore, H2 is supported.

Discussion

The goal of this research was to further the understanding of implicit contracts between the EMT and the acquiring firm during the acquisition process. Our results lead us to make two observations. First, the development of implicit contracts aids in the retention of the EMT, and second, that post-acquisition performance of the acquired firm is aided by the development of the EMT’s implicit contract. Below, we discuss the implications of these findings.

In the current global marketplace, speed to develop new products and new features, to the marketplace, innovations, etc. now rivals quality and customer service due to finicky customer preferences, fluidity of knowledge transfer, and ever-shortening product life cycles. As such, increasingly, larger firms are acquiring innovative entrepreneurial firms and are relying upon the individuals driving these firms to provide valuable core competencies and skills to complement their arsenal of competitive resources. Typically, the source of these entrepreneurial firms’ success and commercial viability are the EMT who have intimate knowledge of the product, future trends, and customers’ preferences for their product. Our results confirm that, along with the explicit contracts offered to the acquired firms’ EMT, an implicit relationship needs to be transferred. Transference of the implied contract helps ensure that institutional memory and tacit knowledge, crucial resources to the ongoing success of the newly formed entity, is captured.

From the acquiring firms’ perspective, although access to the acquired entrepreneurial firms’ intellectual property (patents, copyrights, etc.) may provide a short term advantage, the retention and inclusion of the EMT will provide continuous innovation and imitable talent-related resources into the acquiring firm. When members of the EMT leave the acquiring firm after acquisition due to numerous reasons (possible loss of autonomy, enriched, pursue new challenges, corporate culture clash, etc.) due to the implicit contract being ignored, our results indicate that performance is not optimized.

Though there is evidence that implicit contracts between employees and their firm is developed over time, our results point to there being immediate benefit if implicit contracts are included as an imperative between the EMT and the acquiring firm. That statistical significance for implicit contract development was demonstrated to both retention of the EMT and post-acquisition performance highlights the importance of the connection between the implicit contract and the EMT.

Conclusion

Acquisitions are an increasingly popular strategy to acquire skills and competencies that firms either can not, or do not have the time to, develop organically. The focus of the skills and talents that are embodied in a successful entrepreneurial firm
are the EMT and thus the implicit contract needs to be developed before, during and after acquisition if an acquiring firm wishes to retain these individuals.

References


Table 1
Correlation Table

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* p < 0.05  ** p < 0.01
Table 2 (H1). Hierarchal Regression model of Implicit Contract Transference to EMT Retention

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Table 3 (H2). Hierarchal Regression model of Implicit Contract Transference and Performance

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