Finance Research Letters 12 (2015) 109–116

Contents lists available at ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

Estimating the effect of entrenched boards on firm value using geographic identification ☆

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ARTICLE INFO

Article history:
Received 29 September 2014
Accepted 14 November 2014
Available online 20 November 2014

JEL classification:
G32
G34

Keywords:
Staggered boards
Classified boards
Entrenched boards
Firm value
Geography

ABSTRACT

We show that firms located geographically close to one another share a similar probability of having staggered boards (or classified boards), an effect probably due to investor clientele, local competition, and social interactions. We then exploit the variation across the zip codes in the incidence of staggered boards and estimate the effect of staggered boards on firm value (measured by Tobin's Q). We use as our instrumental variable the proportion of firms located in the same zip code that have staggered boards, excluding firm *i*. The evidence shows that staggered boards reduce firm value significantly.

1. Introduction

An intense debate has continued for decades on the costs and benefits of staggered boards (or classified boards), making board classification one of the most controversial corporate governance

☆ Part of this research was carried out while Pornsit Jiraporn served as Visiting Scholar at Chulalongkorn University, SASIN Graduate Institute of Business Administration. This research is sponsored by The Kanchanapisek Chalermphrakiat Endowment, The Office of Academic Affairs, Chulalongkorn University.

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http://dx.doi.org/10.1016/j.frl.2014.11.002
1544-6123/

provisions. Proponents of board classification argues that staggered boards promote continuity and stability, thereby reducing the detrimental effects of "myopia", where managers focus excessively on short-term goals, at the expense of long-term benefits. Furthermore, an argument has been made that, when a firm faces a takeover attempt, board classification allows managers to negotiate a more favorable deal for the shareholders. Opponents of staggered boards, on the contrary, contend that staggered boards insulate inefficient or opportunistic managers from removal, either from a takeover or from a proxy contest. Secured in their positions, managers are entrenched and more likely to engage in actions that maximize their private benefits at the expense of the shareholders, thereby exacerbating the agency conflict and reducing firm value.

Although prior research has attempted to explore the effect of staggered boards on firm value, it remains challenging to draw a causal inference, due to endogeneity. The purpose of our study is twofold. First, we argue that firms located close to one another geographically share similar governance preferences, including having (or not having) staggered boards. Using geographical identification based on zip codes, we hypothesize that the probability of a given firm having a staggered board is related to the prevalence of staggered boards in the neighboring firms in the same zip code. Second, we exploit the variation across the zip codes in the incidence of staggered boards and estimate the effect of staggered boards on firm value, under the assumption that zip code assignments are exogenous. Zip codes are assigned to maximize efficiency in mail delivery and therefore do not reflect corporate policies or outcomes. Also, zip code changes usually reflect demographic and urban developments and, as a consequence, are unlikely related to corporate policies. The variation in the incidence of staggered boards across the zip codes is thus likely exogenous (Jiraporn et al., 2014). It is this exogenous variation that we exploit to establish a causal inference.

There are a number of reasons why neighboring firms tend to share similar preferences for corporate governance. First, the similarity can be attributed to local shareholders (both institutional and individual), who tend to own shares of local firms (Coval and Moskowitz, 1999; Ivkovic and Weisbenner, 2005; Pirinsky and Wang, 2006; Jiraporn et al., 2014). Because local firms share local shareholders, their governance arrangements should be similar. For instance, firms located in an area where local investors exhibit a negative view against staggered boards are probably much less likely to have staggered boards. Second, local competition is expected to be a critical factor. Strong governance that enhances shareholders' power is usually viewed positively by investors. How investors view a firm's corporate governance may depend in part on the governance policies of the neighboring firms. For instance, investors may have a negative view of a firm if its governance is much weaker than that of the surrounding firms. On the contrary, a firm may be particularly admired by local investors if they outperform their neighbors in terms of corporate governance. Local investors who are particularly conscious of governance may shun away from a company with poor governance if there are other firms nearby with stronger governance. For this reason, when formulating its governance policy, a firm must take into consideration the governance policies of the surrounding firms. Local competition to attract investors forces the corporate governance of geographically-proximate firms to be similar.

Third, social interactions and peer effects can be particularly important for corporate decision makers. Managers who work in the same geographic area usually have opportunities to network and build valuable relationships with their peers, exchanging ideas and learning from one another's experience (Pirinsky and Wang, 2010). When formulating a governance policy, corporate executives may turn to their peers for ideas about appropriate strategies or mimic one another's behavior through direct contact. The social interactions and peer effects of the executives in the same geographic area make the governance policies of the neighboring firms more similar.

Consistent with the above arguments, our evidence shows that a given firm is more likely to have a staggered board if a larger proportion of the surrounding firms have staggered boards. The marginal peer effect of geography on the likelihood of having a staggered board is 19.25%. Our instrumental-variable analysis shows that firm value is significantly lower with the presence of a staggered board. Our instrument is the proportion of firms with staggered boards in the same zip code, excluding firm *i*. Therefore, our instrument comes from *outside* the firm and is probably exogenous. Because our