Journal of Accounting and Economics 63 (2017) 142–160

Contents lists available at ScienceDirect

Journal of Accounting and Economics

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

Takeover defenses: Entrenchment and efficiency ☆

Sanjeev Bhojraj [a,*], Partha Sengupta [b], Suning Zhang [c]

[a] S.C. Johnson School of Management, Cornell University, Ithaca, NY 14853, United States
[b] Enterprise Risk Analysis Division, Office of the Comptroller of the Currency, 400 7th Street SW, Washington DC 20219, United States
[c] Henry B. Tippie College of Business, University of Iowa, Iowa City, IA 52242, United States

ARTICLE INFO

Article history:
Received 4 September 2014
Received in revised form
28 November 2016
Accepted 2 December 2016
Available online 10 December 2016

Keywords:
Corporate governance
Takeover defenses
Anti-takeover provisions
State anti-takeover legislation
Firm value
Managerial myopia

ABSTRACT

This paper explores the potential role of anti-takeover provisions (ATPs) in long-term value creation. Using a change in the legal environment in Delaware as an exogenous event, we document that a subset of firms with a relatively longer term focus (innovative firms) benefit from ATPs. Particularly, these firms experience an increase in Tobin's Q following a state law change in Delaware that increases the effectiveness of ATPs in defending against hostile takeovers. This increase is greater than that for non-innovative firms in Delaware as well as for innovative firms outside Delaware. Furthermore, the innovative firms in Delaware experience a stronger positive market reaction around the state law change dates, relative to other firms. Finally, in a cross-sectional setting we find that innovative firms with above-average takeover protection outperform other firms and are less likely to engage in harmful real earnings management. Taken together, these results provide empirical evidence of potential benefits of ATPs and help explain why such protection continues to be prevalent in the United States.

1. Introduction

Corporate takeovers have lon g been considered a governance mechanism that can help reduce management entrenchment and improve productive efficiency of management (e.g., Grossman and Hart, 1980; Fama, 1980; Jensen and Ruback, 1983; Scharfstein, 1988, Jensen, 1993).[1] Consequently, firms that have antitakeover provisions (henceforth ATPs) in place are often considered to be relatively inefficient. Consistent with the perceived inefficiency of ATPs, a stream of research finds that high ATP firms have lower accounting performance, lower Tobin's Q, and lower reinvestment rates, relative to low ATP firms (e.g., Gompers, Ishii and Metrick, 2003; Bertrand and Mullainathan, 2003; Bebchuk and Cohen, 2005; Bebchuk, Cohen and Ferrell, 2009; Cohen and Wang, 2013). However, despite negative portrayals in much of the archival research and popular opinion, ATPs remain prevalent among the S&P 500 companies, with about 60% of these firms having staggered

☆ We would like to give special thanks to Charles Wang, Joanna Wu (editor) and an anonymous reviewer for their detailed and constructive feedback on the paper. We would also like to thank Philip Berger, Robert Bloomfield, Richard Frankel, Carol Marquardt, Kenneth Merkley, Partha Mohanram, Haresh Sapra, Mary Stanford and workshop participants at Cornell University, Baruch College, Washington University, 2013 American Accounting Association Annual Meeting, 2013 Annual Rotman Accounting Research Conference, 2014 Harvard University Information, Markets and Organizations Conference, and 2014 Washington Area Accounting Research Symposium for many helpful suggestions. The views expressed are those of the authors and are not necessarily those of the Office of the Comptroller of the Currency.

* Corresponding author.
E-mail addresses: sb235@cornell.edu (S. Bhojraj), partha.sengupta@occ.treas.gov (P. Sengupta), suning-zhang@uiowa.edu (S. Zhang).

[1] Managerial entrenchment could manifest in several ways, including shirking, empire building, perks, higher compensation, and encouraging managers to take on lower risk than is optimal for the firm (Borokhovich et al., 1997; Bertrand and Mullainathan, 2003; Low, 2009).

http://dx.doi.org/10.1016/j.jacceco.2016.12.001
0165-4101/

boards and poison pills in place. These provisions are also common in the charters of initial public offerings (Daines, 2001; Daines and Klausner, 2001). If ATPs unambiguously lead to inefficiencies, the question arises as to why market forces have not eliminated their use over time.

In this paper we attempt to address this disconnect by exploring the potential role of ATPs in long-term value creation. We identify a set of firms focused on long-term growth (innovative firms) that are most likely to benefit from ATPs and use an exogenous event to isolate the benefit.[2] We suggest that while the threat of corporate takeovers can curb managerial inefficiencies, it can also create incentives for myopic behavior by managers. Fear of takeover and the associated employment risk may cause managers to take actions that are focused on maximizing short-term price rather than long-term value. Jensen (2005) states that "when numbers are manipulated to tell the market what they want to hear … and when real operating decisions that would maximize value are compromised to meet market expectations, real long-term value is being destroyed.". Stein (1988) argues that ATPs can help managers pursue long-term goals more effectively by insulating them from short-term market pressures. The reasoning is that capital market pressures, including the threat of takeovers and the associated employment risk, can cause management to behave myopically, shun projects that may carry a higher risk of early failures, and focus on maximizing short-term price (Holmstrom, 1989). Manso (2011) proposes a similar argument for managerial protection as a means of encouraging innovation. Rather than taking a one-size-fits-all view of ATPs and estimating their average effect on all firms, we explore a setting where such provisions can be beneficial to investors.[3]

We use a number of alternative designs to explore the effect of anti-takeover protection on innovative and non-innovative firms. Our primary research design is to explore the effects of a state law change in Delaware that significantly increased the takeover costs of firms incorporated there. Bebchuk and Cohen (2005), Low (2009), and Atanassov (2013) discuss how the implementation of state law change in Delaware in 1995 made it easier for firms to use certain takeover defenses such as poison pills to block hostile takeovers. We examine the effect of this exogenous event on a firm's Tobin's Q. Using a difference-in-difference approach, we examine the effect of the regime change on innovative firms incorporated in Delaware and compare it to the effect on other firms. We find that after the change in state law, Delaware-based innovative firms enjoyed a significant improvement in their Tobin's Q compared to both Delaware-based non-innovative firms and non-Delaware-based innovative firms.

Given that the state law change was particularly relevant to firms with poison pills and staggered boards in place, we explore whether its effect is stronger for firms with above-average protection. Using data obtained from the *Investor Responsibility Research Center* (IRRC), we partition the sample into *protected* and *unprotected* firms using three alternative measures of takeover protection: presence or absence of poison pills (*PPILL*), presence or absence of staggered boards (*SB*) and above/below median value of the entrenchment index (*EINDEX*) proposed by Bebchuk et al. (2009).[4] Using these three measures, we compare the effects of the Delaware law change for protected and innovative (*PI*) firms relative to the other groups. We find that Delaware-based *PI* firms experience a statistically and economically significant improvement in their Tobin's Q subsequent to the state law change. This improvement is greater than those experienced by all other Delaware-based firms, including the unprotected and innovative (*UPI*) firms and the protected and non-innovative (*PNI*) firms.

We perform additional analyses using an event study design around the dates on which the court rulings were announced. The first date is January 11, 1995 when the Supreme Court of Delaware allowed Unitrin Inc. to use both a poison pill and share repurchases to fend off a hostile takeover bid from American General Corp. The second is December 4 1995, when the U.S. District Court for the District of Delaware denied Moore Corp. Ltd.'s motion against the use of poison pills as an antitakeover mechanism by Wallace Computer Services Inc. Using these two dates as our focal points, we examine 2-day and 4-day cumulative abnormal returns subsequent to the ruling dates for *PI* and *UPI* firms. The results show that *PI* firms experience greater cumulative abnormal returns subsequent to the rulings than *UPI* firms do, and these results are statistically significant for *PPILL*- and *EINDEX*-based measures of protection. In order to rule out the alternative explanation that *PI* firms outperform *UPI* firms in general and not just on the state law change dates, we bootstrap the empirical distribution of the difference between cumulative abnormal returns of *PI* and *UPI* firms around other dates. Our results do not support the alternative hypothesis.

Overall, the results of our tests based on the state law change events are consistent with the idea that takeover protection can benefit a set of firms, and that markets seem to understand this benefit. Therefore, while some firm managers can certainly use takeover protection to reap private benefits, others can use the protection to maximize long-term goals of shareholders more effectively.

We conduct additional analyses to compare Tobin's Q of *PI* and *UPI* firms in a cross-sectional setting. Prior to this comparison, however, we employ a propensity score matching sample methodology to pair *PI* firms with *UPI* firms based on firm characteristics. This helps to reduce the likelihood that the results of a cross-sectional analysis are driven by other

[2] We also use an alternative outcome-based definition of innovation based on patent counts along the lines of Atanassov (2013) and Sapra et al. (2014). The results based on this definition are similar and are discussed in Section 6.

[3] Cohen and Wang (2013) allude to this issue when they state, "Because we estimate the average treatment effect of staggered boards for the affected firms in our sample, we cannot rule out the possibility that staggered boards might have heterogenous effects. Future empirical work might consider how the impact of staggered boards on firm value varies for different types of firms. For example, useful toward understanding the value implications of staggered boards (and of takeover defenses in general) would be to empirically identify subsets of firms for which the effect is zero or positive" (page 628).

[4] Bebchuk et al. (2009) examined the 24 corporate charter provisions that IRRC provides data on, and identified six of these as most susceptible to shareholder resistance. Their entrenchment index is the number of these six provisions a firm has in place.