Journal of Economics and Business 72 (2014) 30–43

Contents lists available at ScienceDirect

Journal of Economics and Business

Antitakeover provisions, managerial entrenchment and firm innovation

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ARTICLE INFO

Article history:
Received 17 February 2012
Received in revised form 5 June 2013
Accepted 9 October 2013

JEL classification:
O16
O31
O32
G31
G34

Keywords:
Patents
Citations
R&D
Entrenchment
Corporate governance

ABSTRACT

We explore the relation between antitakeover provisions (i.e. managerial entrenchment) and firm performance in innovation. Empirical results indicate that an increase in antitakeover provisions is negatively related to number of patents and number of citations to patents. Thus managers who are protected from takeover market perform worse on innovation. However, the negative relation between antitakeover provisions and firm innovation holds only for low-tech firms. For high-tech firms, this relation is not statistically significant. One possible explanation is that high-tech firms have to innovate continuously to survive in the long run. The competitive pressure to innovate or perish dissipates the negative effect of managerial entrenchment on firm innovation. Overall, our results support the agency based explanation of the relation between antitakeover provisions and firm performance in innovation.

1. Introduction

Firm innovation plays a critical role in creating, sustaining and adding firm value. However, investment in innovative activities is a higher risk investment compared to investment in capital expenditures due to higher probability of failure (Bhagat & Welch, 1995; Holmstrom, 1989). Since

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0148-6195/$ – see front matter
http://dx.doi.org/10.1016/j.jeconbus.2013.10.001

R&D expenditures cannot be capitalized, investment in innovation depresses short term accounting earnings and reduces accounting based bonuses for managers. Moreover, investment in innovation is characterized by long gestation periods as cash flows could stretch beyond the tenures of managers (Dechow & Sloan, 1991; Gibbons & Murphy, 1992). Consequently, risk-averse managers may not have incentives to invest in innovation. However, firms that do not innovate lose market value and become desirable takeover targets. Thus the presence of an active external control market disciplines managers and forces them to invest in risky but value-maximizing projects. Managers do not like the takeover pressures and have incentives to favor antitakeover provisions that protect them from such pressures.

Although antitakeover provisions have been studied in literature, there is no theoretical consensus on their effect on firm innovation. The agency cost based "*managerial entrenchment hypothesis*" argues that protecting managers from market for corporate control makes management more entrenched and further misaligns the interests of managers from those of shareholders (DeAngelo & Rice, 1983; Jensen & Meckling, 1976; Jensen & Ruback, 1983). The managerial entrenchment view thus predicts that antitakeover provisions increase entrenchment and negatively affect managerial incentives to innovate.

On the other hand, the "*managerial myopia hypothesis*" asserts that the threat of a hostile takeover and the resulting career concerns about possible job loss make managers myopic and force them to make short-sighted investment decisions (Scherer, 1982; Stein, 1988). Stein (1988) argues that shareholders cannot value investments in innovation due to information asymmetry and drive down the market value of companies that make such investments, exposing these companies to takeover threats. Consequently, managers invest only in short term projects that the market can easily evaluate and avoid making investments in long term innovative projects. Protecting managers from takeover threats encourages them to take long term view and invest in innovation. Thus the managerial myopia view predicts a positive relation between antitakeover provisions and firm innovation.

Given the absence of theoretical consensus, the relation between antitakeover provisions and firm innovation is an empirical question. This paper estimates the relation between antitakeover provisions and firm innovation. Following the current literature on antitakeover provisions, we call the presence of antitakeover provisions "managerial entrenchment". Bebchuk, Cohen, and Ferrell (2009) construct an entrenchment index (E-index) from the corporate charter provisions of the Investor Responsibility Research Centre (IRRC). We use their index to measure managerial entrenchment.

We use number of patents and number of citations to patents held by a firm to measure firm performance in innovation. Our results indicate that managerial entrenchment is negatively related to firm performance in innovation. An increase in entrenchment (i.e. increase in E-index) leads to poor performance on both measures of firm innovation. Prior research has shown that a subset of charter provisions that increases managerial entrenchment is associated with lower firm value (Bebchuk et al., 2009).[1] Our results provide an explanation of the link between entrenchment and firm value – the same provisions that reduce firm value are also associated with lower performance in innovation. Thus, increased managerial entrenchment could lower firm value via its negative impact on firm innovation.

We also examine if the relation between entrenchment and innovation is sensitive to industry characteristics. Here our results indicate that the negative relation between entrenchment and innovation is sensitive to firm being a low-tech or high-tech. The negative coefficient on E-index is not statistically significant at any conventional level for high-tech firms. It is statistically significant only for low-tech firms. One possible explanation is that high-tech firms by definition are innovative. Their survival and long-run profitability depends on constant innovation. Moreover, intense product market competition and rapid product obsolescence force such firms to innovate. The negative impact of entrenchment for these firms is dissipated by positive competitive pressures.

Rest of the study is organized as follows. Section 2 provides motivation and hypotheses. Section 3 discusses measures of managerial entrenchment and innovation. Section 4 describes data and sample construction. Section 5 discusses empirical methodology, Section 6 presents results and Section 7 concludes.

[1] This result is consistent with the broader literature that suggests that weak shareholder rights are associated with greater agency problems and lead to poor firm performance (Becht et al., 2003).