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Shareholder democracy in play: Career consequences of proxy contests ☆

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ABSTRACT

This paper shows that proxy contests have a significant adverse effect on careers of incumbent directors. Following a proxy contest, directors experience a significant decline in the number of directorships not only in the targeted company, but also in other nontargeted companies. The results are established using the universe of all proxy contests during 1996–2010. To isolate the effect of the proxy contest, our empirical strategy uses within-firm variation in directors' exposure to the possibility of being voted out and exploits the predetermined schedule of staggered boards that allows only a fraction of directors to be nominated for election every year. We find that nominated directors relative to non-nominated ones lose 58% more seats on other boards. The evidence suggests the proxy-contest mechanism imposes a significant career cost on incumbent directors.

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1. Introduction

Shleifer and Vishny (1997, p. 737) explain that “corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment.” The fundamental feature of corporate governance is shareholders' right to elect directors to represent their interests. For corporate governance to be effective, shareholders who are dissatisfied with a board's performance must have a mechanism for replacing directors. If shareholders' impact on electing and replacing directors is weak, so is the connection between owners and managers.

The purpose of this paper is to investigate whether proxy contests affect the careers of directors whose companies have been targeted. Specifically, the paper aims to shed light on whether shareholders are able to impose a career cost on directors when they are dissatisfied with firm performance.

Shareholders have two main tools for removing poorly performing directors. First, shareholders can use an uncontested election. Prior literature has shown that attempts to remove directors through uncontested elections have not been effective. In regular elections, shareholders cannot technically vote out a director but, instead, can only withhold their authority to vote in favor of a nominee.

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Most US firms have plurality voting rules in uncontested elections, and as a result, removing directors in uncontested elections is almost impossible. Specifically, a director can be reelected even if just a few shareholders vote for him. Thus, the prospect of shareholders having an effective voice in removing directors in uncontested elections seems limited, and directors do not appear to suffer reputational effects from low votes (Cai, Garner, and Walkling, 2009).

Second, shareholders can discipline directors through proxy contests. Dissatisfied shareholders can nominate an alternative slate of directors by initiating a proxy contest and, therefore, provide all shareholders with a clear alternative to incumbent nominees. Despite this mechanism, no evidence exists supporting the idea that directors who are targeted in proxy contests suffer any career consequences.

Despite the absence of evidence, the question about the effectiveness of the proxy-contest mechanism in imposing career costs on directors is even more important these days. First, proxy contests have become more frequent. The number of contests for board seats increased from 270 contests during 1979–1994 (Mulherin and Poulsen, 1998) to 706 during our sample covering 1996–2010, indicating a 160% increase in the frequency of proxy contests (See Table 1). Second, the relative importance of the proxy-contest mechanism increased as well. Fig. 1 indicates a significant change in corporate governance over the last three decades. Whereas in the 1980s dissident shareholders more often relied on hostile tender offers, during the last decade they have relied more often on proxy contests.[1] Finally, a new class of activist shareholders has arisen: activist hedge funds. Activist hedge funds face limited regulatory constrains and can be effective in exploiting the proxy-contest mechanism (Brav, Jiang, Partnoy, and Thomas, 2008).

In addition to their importance as a corporate-governance mechanism, proxy contests offer an interesting setting in which to study whether shareholders can impose career costs on directors. A necessary condition for a proxy contest to emerge is a dissatisfaction of shareholders with the board's performance. Dissidents typically target under-performing firms, and proxy contest announcements are greeted with a positive stock price reaction (Fos, 2013). Therefore, if the labor market for directors is well functioning, proxy contests should have a negative impact on the careers of directors. As a result, evidence on the negative career effects of proxy contests would be consistent with a well-functioning labor market for directors. Also, strong career effects of proxy contests would suggest a viable connection between providers of capital (i.e., shareholders) and their agents (i.e., management) and would show that suppliers of capital have at their disposal a

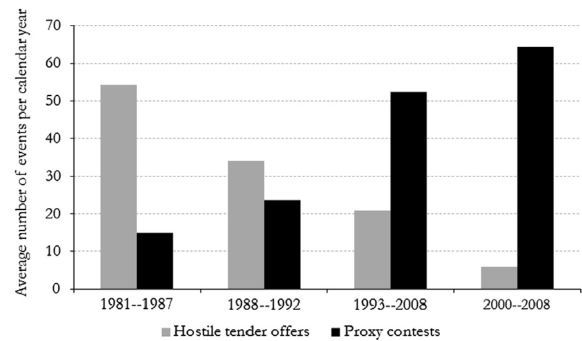

Fig. 1. Raise of proxy contests and disappearance of hostile tender offers. This figure is borrowed from Fos (2013). The dark bars plot the average number of proxy contests initiated each year during four sample periods. The gray bars plot the average number of hostile tender offers initiated each year. The hostile tender offers data are from the Thompson Reuters Securities Data Company database.

mechanism for replacing directors when they are dissatisfied with their performance.

Using hand-collected data on all proxy contests during 1996–2010, this paper fills the gap in the literature and studies whether contests for board seats have an impact on the careers of incumbent directors. In contrast to normal shareholder meetings when shareholders have no real choice in terms of board nominees, incumbent directors face a direct threat of replacement because dissident shareholders nominate an alternative slate of candidates. That is, corporate elections in these cases resemble real democracy.

We show that proxy contests are associated with significant adverse effects on the careers of incumbent directors. Following a proxy contest, incumbents lose seats from on targeted boards. Three years after the proxy contest, more than 39% of the directors are not on the board of the targeted company. Furthermore, following a proxy contest, directors experience a significant decline in the number of seats on other boards. The total number of other directorships falls by more than 17% over the three years after the proxy contest. Overall, facing a direct threat of removal is associated with $1.3–$2.9 million in foregone income until retirement for the median incumbent director.[2]

We provide numerous tests that show the robustness of our results. Our results are robust when we investigate the effect of proxy contests on other public seats the directors hold. Therefore, our results show that directors lose outside directorships in both public and private firms. Furthermore, in our specifications we address possibly endogenous sources of variation in the number of directorships. Changes in directorships might be driven by aggregate trends in the labor market for directorships. To address this concern, we augment specifications with year fixed effects. Also, one could argue that the results could be driven by firms that have high director turnover, by under-performing firms, by an unobserved director characteristic (e.g., low ability), or by the match of firms and directors (e.g., low-ability directors are more likely to join

[1] The widespread adoption of antitakeover provisions and the enactment of state-level antitakeover laws favoring management have increased the cost of a hostile tender offer and, therefore, have contributed to the decrease in the frequency of hostile tender offers (Karpoff and Malatesta, 1989; Bertrand and Mullainathan, 2003; Cremers and Ferrell, 2010). By contrast, the 1992 proxy reform, which allowed independent shareholders to freely engage in communication without being monitored by the Security and Exchange Commission, is one potential explanation for the increasing frequency of proxy contests (Sharara and Hoke-Witherspoon, 1993; Bradley, Brav, Goldstein, and Jiang, 2010; Fos, 2013).

[2] Outside directorships also provide prestige that broadens the director's network and visibility (e.g., Mace, 1986).

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