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Classified boards, firm value, and managerial entrenchment ☆

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Abstract

This paper shows that classified boards destroy value by entrenching management and reducing director effectiveness. First, I show that classified boards are associated with a significant reduction in firm value and that this holds even among complex firms, although such firms are often regarded as most likely to benefit from staggered board elections. I then examine how classified boards entrench management by focusing on CEO turnover, executive compensation, proxy contests, and shareholder proposals. My results indicate that classified boards significantly insulate management from market discipline, thus suggesting that the observed reduction in value is due to managerial entrenchment and diminished board accountability.

JEL classification: G34

Keywords: Classified boards; Managerial entrenchment; Executive compensation

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1. Introduction

On April 23, 2003, 85% of the shares represented at Baker Hughes' annual meeting were voted in favor of a shareholder proposal asking the company to declassify its board and elect all directors annually. According to the Investor Responsibility Research Center (IRRC), Baker Hughes was only one of several companies facing shareholder agitation on classified boards during the 2003 proxy season. On its web site, IRRC identified 56 shareholder proposals dealing with classified boards and counted the issue as one of the two key governance-related proposals for the year.

The election of directors is the primary avenue for shareholders to participate in corporate affairs. In general, directors are elected for one-year terms at the firm's annual meeting. Activist shareholders and institutional investors argue that this encourages effective monitoring by giving shareholders the opportunity to retain or replace directors each year. In addition, annual elections ensure that the entire board can be replaced at once in the event of a hostile acquirer making a successful bid for the company. Since a hostile bid is more likely to succeed when the firm's performance is poor, it is argued that this threat motivates management to act in ways that maximize shareholder wealth.

Nevertheless, a majority of American corporations have classified boards. According to Rosenbaum (1998), 59% of major US public companies elected directors to staggered terms in 1998. Under this provision, the board is divided into separate classes, usually three, with directors serving overlapping multiyear terms. Thus, approximately one-third of all directors stand for election each year, and each director is reelected roughly once every three years.

Proponents contend that this provides a measure of stability and continuity that might not be available if all directors were elected annually, which is presumed to enhance the firm's ability to create value. Besides, Wilcox (2002) and Koppes, Ganske, and Haag (1999) argue that staggered elections encourage board independence by reducing the threat that a director who refuses to succumb to management will not be renominated each year. Furthermore, firms with classified boards might attract better directors if directors dislike going through the election process and prefer to avoid annual reelection. Staggered elections also might enhance shareholder value in takeover situations by allowing the target's board enough time and the perspective to accurately evaluate bids and solicit competing offers. Thus, the question of whether classified boards benefit or hurt shareholders is largely an empirical matter.

Jarrell and Poulsen (1987) study antitakeover charter amendments and find a negative but insignificant average abnormal return for their subsample of 28 classified board announcements. In contrast, Mahoney and Mahoney (1993) find a significantly negative abnormal return for a sample of 192 events. Bebchuk, Coates, and Subramanian (2002) analyze 92 hostile bids for US corporations between 1996 and 2000 and find that a classified board almost doubles the odds that a hostile target remains independent. They also find that classified boards do not confer higher premiums if the target is acquired. More recently, Bebchuk and Cohen (2005) study the effect of staggered elections on firm value as measured by Tobin's q. They find that classified boards are associated with a significant reduction in firm value.

In spite of these studies, several issues remain unresolved. For instance, are classified boards universally bad, or do some firms benefit from electing directors to staggered terms? This is an important question because a negative average effect need not imply the absence