COMMITMENT AND ENTRENCHMENT IN CORPORATE GOVERNANCE

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EMPIRICAL MOTIVATION

- Controversial results in empirical corporate governance:
  - Higher number of governance provisions decrease firm value (Gompers, Ishi & Metrick 2003) → **insignificant in the time series with clustering**.
  - Staggered boards decrease firm value (Bebchuk, 2007) → **opposite result in the time series and once identification is improved**;
  - More flexible and shareholder friendly corporate law jurisdictions (i.e., Delaware) increase firm Value (Daines, 2002) → **opposite results in the time series and with IV**.
  - **Only a few (selected) corporate governance provisions matter → These provisions (substantially) decrease firm value (Bebchuk & Coen 2010).**

E-Index

- E-Index (**more than 350 law and finance articles cite it!**):
    - Staggered Board;
    - Poison Pill;
    - Supermajority to Amend Charter;
    - Supermajority to Amend Bylaws;
    - Supermajority to Approve Merger;
    - Golden Parachute.
- Shareholder protection (i.e., reduction of board authority) is efficient → Shareholder Democracy.

Theoretical Framework

Separation of Ownership and Control

- Gives rise to twin 'Agency Problems':
- **Moral Hazard** (of managers and entrenched board)
  - Due to **management–shareholder conflict of interest**
  - Addressed by *Shareholder Empowerment View*
- **Limited Commitment** (due to shareholders' exit rights)
  - Due to **other-stakeholders–shareholder conflict of interest**
  - Due to **technology** with high private information
  - Addressed by *Director Primacy View*

THEORETICAL MOTIVATION

Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense

Ronald J. Gilson*

Responding to my comments in the *Stanford Law Review*,[1] and to those of Lucian Bebchuk in the *Harvard Law Review*,[2] Professors Easterbrook and Fischel have reiterated their preference for a rule of pure passivity by target management in response to a tender offer. Unlike my more limited rule barring defensive tactics designed to prevent the offer but not barring the facilitation of competitive bids, Easterbrook and Fischel would prohibit both.[3] Because their response to the points that Bebchuk and I raised goes beyond their initial treatment of the subject, it is appropriate that I respond here by extending the arguments I originally presented.

As originally put, Easterbrook and Fischel argued that auctioneering was undesirable because of the sunk costs in information incurred by the original bidder. If a competitive bid was successful, the unsuccessful first bidder would be unable to recover these costs; the risk of this occurrence would reduce the incentive to invest in information in the first place. Therefore, monitoring would decrease and

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* Associate Professor of Law, Stanford University. I am grateful to Professors Frank H. Easterbrook and Daniel R. Fischel for the dialogue reflected in this exchange. I look forward to the opportunity to disagree with each of them on small parts of major positions in the future. I am also grateful to Lucian Bebchuk, Bernard Black, Henry Hansmann, Thomas Jackson, Roberta Romano, and participants in the University of Pennsylvania Transaction Costs Economics Workshop for helpful comments on an earlier draft of this article.

1. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 868–75 (1981) [hereinafter cited as Gilson, *A Structural Approach*].

2. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) [hereinafter cited as Bebchuk, *The Case for Facilitating Competing Tender Offers*]. Bebchuk expands his position in this exchange. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter cited as Bebchuk, *A Reply and Extension*].

3. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Auctions and Sunk Costs*]. They first stated their position in Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175–80 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role of a Target's Management*].

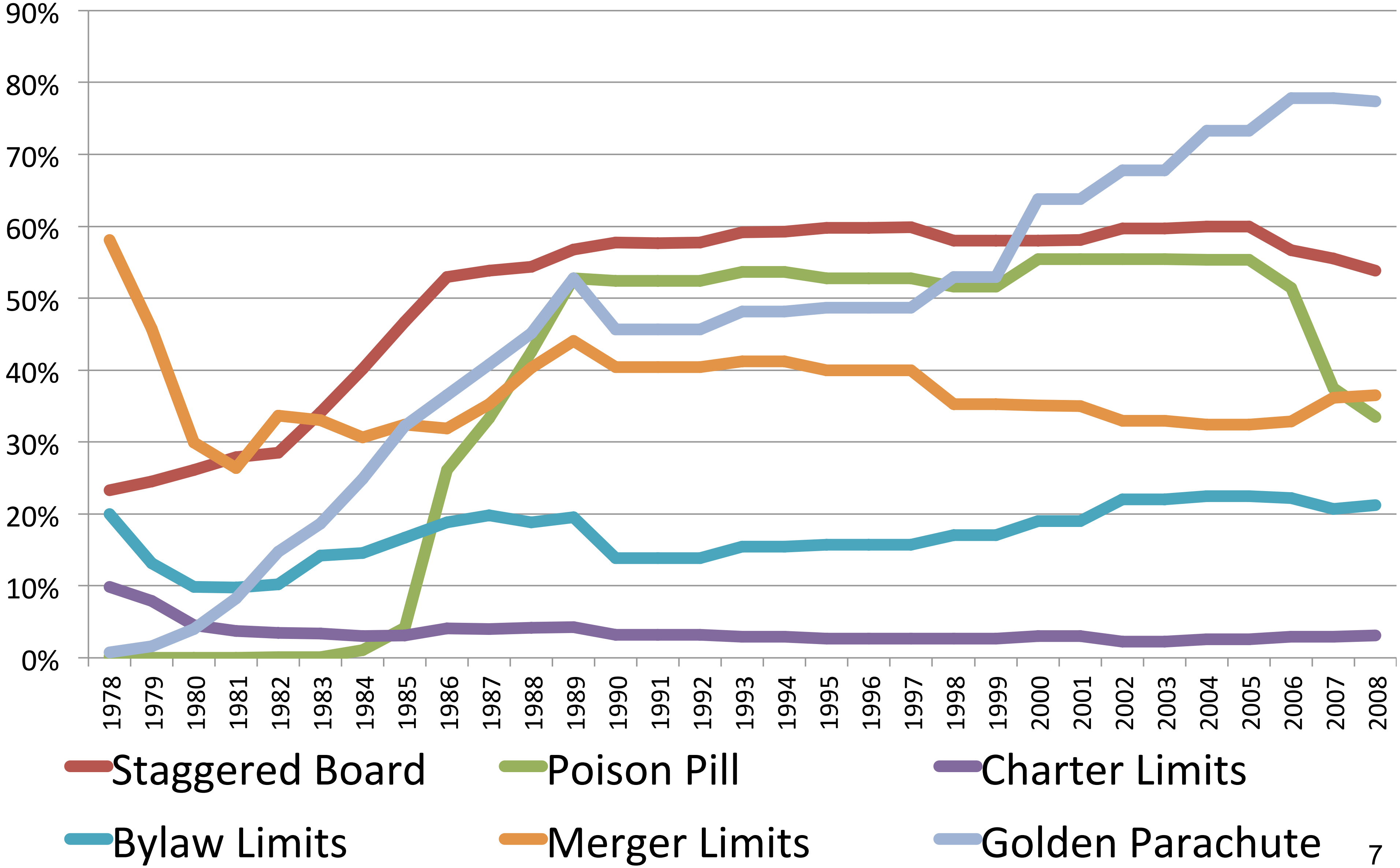
Defensive tactics requiring shareholder approval (e.g., staggered boards), may be an efficient commitment from shareholders to managers and boards not to dismiss these agents prematurely

DATA

- **Independent Variables:**
- 1978–1989 hand-collected information.
- 1990–2008 from Risk Metrics, previously Investor Responsibility Research Center (IRRC)
  - » Hand-checked missing years in the 1994–2006 using proxy statements (SEC's EDGAR)

- **Firm Value and Controls**
- Q → Compustat.

VARIATION IN E-INDEX PROVISIONS



CROSS-SECTION ANALYSIS

Dep. Variable: *Q*								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Indep. Variables								
E-Index	-0.0453***							
	(-11.45)							
	(-5.57)							
Staggered Board		-0.0405***						-0.0234**
		(-4.47)						(-2.06)
		(-2.14)						(-1.03)
Poison Pill			-0.0964***					-0.0722***
			(-9.54)					(-6.20)
			(-4.72)					(-3.25)
SM Charter				-0.00604				0.0216
				(-0.23)				(0.77)
				(-0.11)				(0.39)
SM Bylaws					-0.0391***			-0.0256*
					(-3.00)			(-1.84)
					(-1.57)			(-0.99)
SM Merger						-0.0207**		-0.0139
						(-1.99)		(-1.27)
						(-0.95)		(-0.61)
Parachutes							-0.113***	-0.0918***
							(-10.87)	(-8.10)
							(-5.46)	(-4.24)
Fixed Effects:					Year + Industry			
N	21,414	28,281	27,818	21,455	21,555	21,840	24,348	21,414
R-sq	0.512	0.496	0.501	0.509	0.508	0.510	0.512	0.513

TIME-SERIES ANALYSIS

	Dep. Variable: Q							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Indep. Variables								
E-Index	-0.0137**							
	(-2.13)							
	(-1.07)							
Staggered Board		0.0706***						0.120***
		(5.06)						(6.14)
		(2.30)						(2.96)
Poison Pill			-0.0340***					-0.0377***
			(-3.00)					(-2.80)
			(-1.58)					(-1.58)
SM Charter				0.0748**				0.0743**
				(2.21)				(2.04)
				(1.21)				(1.15)
SM Bylaws					-0.0382*			-0.0630***
					(-1.88)			(-2.99)
					(-1.04)			(-1.66)
SM Merger						0.0269*		0.0117
						(1.69)		(0.70)
						(0.82)		(0.35)
Parachutes							-0.0497***	-0.0608***
							(-4.23)	(-4.62)
							(-2.37)	(-2.67)
Fixed Effects:					Year + Firm			
N	21,414	28,281	27,818	21,455	21,555	21,840	24,348	21,414
R-sq	0.743	0.734	0.735	0.743	0.743	0.743	0.740	0.744

Entrenchment Index Decomposition

Bilateral Provisions

1. Staggered Board
2. Supermajority Requirement to Amend the Charter
3. Supermajority Requirement to Approve Mergers

Commitment Index

(**C-Index**)

Unilateral Provisions

1. Poison Pill
2. Golden Parachute
3. Supermajority Requirement to Amend the Bylaws

Incumbent Index

(**I-Index**)

UNILATERAL PROVISIONS

- Aggravate entrenchment, lower firm value
  - 2nd order: Lower shareholder trust, aggravating commitment problem

BILATERAL PROVISIONS

- Mitigate limited commitment, higher firm value
  - Evidence of increased shareholder trust
  - 2nd order: insiders may abuse this trust, aggravating entrenchment

Commitment & Incumbent Indexes

	Dep. Variable: Q								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Time Period: 1978 - 2008			Time Period: 1978 - 1993			Time Period: 1994 - 2008		
Indep. Variables									
C-Index	0.0508**		0.0610**	0.0164		0.0141	0.0952**		0.101**
	(2.04)		(2.45)	(0.75)		(0.63)	(2.18)		(2.34)
I-Index		-0.0432***	-0.0496***		0.0108	0.0109		-0.0328	-0.0372*
		(-2.81)	(-3.19)		(0.59)	(0.57)		(-1.58)	(-1.80)
Fixed Effects:						Year + Firm			
N	21,438	21,555	21,414	6,663	6,780	6,639	14,775	14,775	14,775
R-sq	0.743	0.743	0.743	0.828	0.825	0.828	0.765	0.765	0.765

INNOVATION AND STAKEHOLDER CHANNELS

- Commitment is especially valuable when innovation and other stakeholders are more involved:
  - **R&D** → How much a firm invest in research and development and innovation → **Managerial specific investment**;
  - **Labor Productivity** → Firm employs more specific labor (higher marginal product), which requires more specific investments → **Labor specific investment**;
  - **Large Customer** → Firm has at least one customer accounting for 10% or more of its sales → **Customer specific investment**.

THE LIMITED COMMITMENT CHANNEL: R&D

	Dep. Variable: Q	
	(1)	**(2)**
Indep. Variables		
E-Index	-0.0155	
	(-1.14)	
C-Index		0.0301
		(1.17)
I-Index		-0.0398**
		(-2.26)
E-Index	-0.0489	
× *R&D*	(-0.16)	
C-Index		1.272*
× *R&D*		(1.70)
I-Index		-0.325
× *R&D*		(-1.01)
N	22,053	22,053
R-sq	0.718	0.719

LIMITED COMMITMENT CHANNEL: LABOR & CUSTOMERS

	Dep. Variable: Q			
	(3)	**(4)**	**(5)**	**(6)**
Indep. Variables				
E-Index	-0.0622***		-0.0173	
	(-3.56)		(-1.30)	
C-Index		0.0382		0.0536***
		(1.03)		(4.44)
I-Index		-0.0921***		-0.0505***
		(-4.06)		(-5.70)
E-Index	0.0392***			
×*Labor Productivity*	(4.37)			
C-Index		0.0441***		
× *Labor Productivity*		(3.27)		
I-Index		0.0333***		
× *Labor Productivity*		(2.67)		
E-Index			0.0156	
× *Large Customer*			(1.11)	
C-Index				0.0356**
× *Large Customer*				(2.22)
I-Index				0.00467
× *Large Customer*				(0.39)
N	18,414	18,414	21,414	21,414
R-sq	0.748	0.749	0.743	0.744

ASSET SUBSTITUTION AND MORAL HAZARD

- Stronger board commitment helps protect creditors and reduce risk of creditor expropriation → Shareholders may prefer expropriate creditors in the short term.
- But, in the long term creditors protection reduce costs of creditor participation.

COMMITMENT, ENTRENCHMENT & RISK

	Dep. Variable: *Z-Score*			
	(1)	**(2)**	**(3)**	**(4)**
Indep. Variables				
E-Index	-0.0935***			
	(-2.71)			
C-Index		0.115*		0.161***
		(1.91)		(2.65)
I-Index			-0.197***	-0.217***
			(-4.46)	(-4.81)
Fixed Effects:	Year + Firm			
N	19,827	19,851	19,962	19,827
R-sq	0.731	0.730	0.732	0.732

ADDITIONAL TESTS

- Same qualitative results (similar statistical and economic significance) under:
- First-Difference; and
- Matching with Q (at t-1), Industry, and Size:
  - For staggered boards; and
  - For supermajority requirements with and without staggered board.

CORPORATE LAW AND BUDGET CONSTRAINT

- Corporations are neither markets nor bureaucracies.
- Markets: hard budget constraint.
- Bureaucracies: soft budget constraint.
- Corporations are hybrid institutions.
- In the **short term** board can go against the market to exploit superior information (e.g., innovation, protect stakeholders), but in the **long term** is accountable to the investors → **Republican Model of Corporate Law**.

Thank You