



Discussion

A discussion of the efficacy of governance in the context of corporate acquisitions: Evidence on staggered boards and institutional trading and voting ☆

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The articles in this volume by [Rose \(2009-this issue\)](#) and [Bethel et al. \(2009-this issue\)](#) examine mechanisms that affect the scrutiny and discipline faced by managers of publicly held firms. Both articles use mergers and acquisitions (M&A) as key corporate events to examine the efficacy of corporate governance. Rose uses outside blockholder concentration as a proxy for the likelihood of a takeover and examines the relation between firm value and staggered boards in firms with high and low outside block holdings. Bethel et al. analyze the institutional market for voting rights around record dates in mergers and how this market relates to the aggregate shareholder support for the mergers. The two articles provide interesting empirical results, but the respective researchers face obstacles that limit their abilities to determine causality. As a result, both articles raise questions that create opportunities for additional research. In what follows, I provide a review of the two articles and suggest opportunities for future research.

[Rose \(2009-this issue\)](#) analyzes the relation between industry-adjusted Tobin's Q and staggered boards, allowing for an interaction effect with outside blockholders. Based on theory (e.g., [Shleifer and Vishny, 1986](#)), he argues that shareholder concentration increases the likelihood of a takeover attempt. If staggered boards entrench managers by insulating them from the threat of takeovers, he reasons that staggered boards will negatively influence firm value when blockholder concentration, and hence the likelihood of takeover, is high. He finds a negative relation between industry-adjusted Q and staggered boards when there are outside blockholders, and no relation when there are none. In specifications that allow for an interaction term, he finds no relation between adjusted Q and an indicator variable for a staggered board, but a negative relation between adjusted Q and the interaction of the staggered board indicator variable and outside blockholder ownership. He interprets these results to support the premise that staggered boards entrench managers when there is a higher probability of a takeover.

The use of outside blockholders as a proxy for the probability of a hostile takeover attempt is a clever idea. Conditioned on a takeover attempt, outside ownership concentration mitigates the free rider problem in [Grossman and Hart \(1980\)](#) to increase

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the probability that the takeover succeeds. However, evidence suggests that blockholders also monitor the firm, for instance by sitting on the board of directors (e.g., [Bertrand and Mullainathan, 2001](#)). Such blockholder monitoring should result in better policies that increase firm value, which would reduce the incentive for disciplinary takeover attempts. Thus, it is not clear that outside blockholder ownership levels provide an unambiguous proxy for the likelihood of a takeover. Although [Rossi and Volpin \(2004\)](#) provide cross-country evidence that ownership concentration is a positive determinant of M&A activity, we have scant empirical evidence for the U.S. market. Providing additional empirical evidence on this relation is a meaningful goal for future research.

Readers should consider two other issues as they interpret the results in this paper. First, staggered boards and outside blockholder ownership are likely endogenously determined. Since very few firms change board classifications during the sample period, it is not feasible to estimate a firm fixed-effects model over the entire sample. The author does estimate an OLS and a fixed-effects model on a sample of 17 firms (79 firm-years) that change board classifications. Although insignificant at typical levels, the sign on the interaction term is negative in the OLS model, but positive in the fixed-effects model. The sample is small, but the sign change raises concerns about a causal link between firm value and the interaction of staggered boards and block ownership. Possibly, one could (i) estimate an industry fixed-effects model to control for endogenous relations at the industry level or (ii) use instrumental variables to control for endogenous relations. The author was unable to identify valid instrumental variables, but researchers should not give up on this quest. Second, robustness tests reported in the paper suggest that the relation between the interaction between staggered boards and outside blockholder ownership is potentially weaker than is reported in the main results. For instance, serial correlation of residuals within firm clusters results in a downward bias of estimates of standard errors. When the author corrects for clustering, he reports lower significance levels.

Staggered boards and outside blockholdings appear to be fairly stable and coexist over time. If staggered boards destroy value, why do blockholders (who presumably can influence policy) not take action to change the board structure? One explanation is that staggered boards exist as a constrained equilibrium mechanism in these firms. As noted by [Hermalin and Weisbach \(2003\)](#), governance mechanisms that persist over time are likely equilibrium outcomes. If so, it is difficult to conclude causality from cross-sectional relations. Going forward, researchers should seek to further unravel potential endogeneity to gain a better understanding of the role of staggered boards. In doing so, it would be useful to contrast the interpretations in [Rose \(2008\)](#) to those in [Bates et al. \(2008\)](#), who conclude that staggered boards do not reduce the likelihood of a firm being taken over. Researchers might also find it productive to compare the results in this study to those in [Cremers and Nair \(2005\)](#), who conclude that activist blockholders and a governance proxy based in part on staggered boards work together as complementary governance mechanisms.

With regard to the second paper, [Bethel et al. \(2009-this issue\)](#) use a proprietary sample of trades by financial institutions to study these institutions' trading activity in the equity of acquiring firms around merger record dates. Relative to a benchmark based on trading activity ten days before and after the record date, they find that financial institutions in their sample are net buyers of acquiring firms' shares with voting rights on and in the days just preceding the record date. Moreover, they find that net buying is heavier when the bidder's stock reaction to the announcement of the merger is worse, and that net buying around the trading date relates negatively to the percentage of shareholder votes in favor of the deal. Data limitations do not allow the authors to observe how these institutions vote, so they cannot infer causality between record date trading and the ultimate vote. The authors suggest several alternative explanations for the results including (i) a monitoring role where institutions send CEOs a message that they disapprove of the transaction and (ii) a conflict of interest argument where institutions buy shares in contentious deals to support management.

The negative relation between net buying and the stock-price reaction to the merger and the negative relation between net buying and the percentage of votes for the merger provide some support for the monitoring story. [Burch et al. \(2004\)](#) find that shareholder support for stock-for-stock mergers relates positively to the acquiring firm's stock-price reaction to the merger announcement. After controlling for net buying around the record date, [Bethel et al. \(2009-this issue\)](#) do not find a significant relation between shareholder support for the merger and the market reaction to the announcement. As noted above, however, they do find negative relations between net buying and the market reaction to merger announcements, and also between voter support and net buying. Possibly, the relation between voter support for the transaction and the announcement returns in [Burch et al.](#) is driven by the net buyers identified by [Bethel et al.](#) If so, the net buying could represent a form of institutional activism.

Providing some support for the conflict-of-interest explanation, the authors find that institutions overweighted in the acquiring firm are larger net buyers around the record date. [Cohen and Schmidt \(2008\)](#) find that mutual fund conflicts of interest that arise from managing firms' pension funds overweight these firms in their portfolios. Since net buyers around the record date also overweight the firm's stock in their portfolios, it is feasible that they are mutual funds with pension-related conflicts of interest. [Ashraf et al. \(2008\)](#) find that mutual funds with pension-related conflicts of interest are more likely to support management on shareholder compensation proposals. It stands to reason that self-interest would lead them to support managers on merger votes as well. An alternative explanation could be that institutions overweight firms in their portfolios when they have better information about the prospects of the firm, and that they buy additional shares on deals that are not favorably received by the market. An analysis of the relation between net buys and the long-run post-merger performance of the firm could provide some insight into this information story.

Regarding the primary empirical findings in [Bethel et al.](#), the documentation of an institutional market for control rights around the record date in mergers and acquisition and its relation to the subsequent vote on the transaction is intriguing, but the reader and future researchers are left to ponder the motivation for this activity and relation. Although a market for control rights is convincingly established, the magnitude of the net buying appears to be far too small to affect the outcome of the merger vote. In fact, the average deal receives approximately ninety-five percent approval. These observations lead to a perplexing question: why

do these institutions purchase the voting rights? As data become available that allow researchers to identify how institutions vote, future research should be able to shed some light on this issue.

There are also some caveats related to data limitations that the reader should consider when interpreting the results in this article. First, the proprietary data is provided by the Abel/Noser Corporation, a company that measures trade execution quality for institutional investors. The sample represents only a fraction of the universe of institutions and institutional trading volume. Since institutions choose to purchase Abel/Noser services, the data set could suffer from a sample selection bias. For instance, larger institutions with deeper pockets might be better able to afford these services and institutions that trade more frequently, and therefore care more about execution quality, might have more need for these services. Thus, although the results in the article establish that there is demand for voting rights around record dates by some institutions, it is not clear that the results characterize behavior that generalizes to population of institutional investors. Second, the dataset does not allow the authors to estimate the true portfolio weights, and the overweighting measure is a rough proxy based on the prior year's cumulative trading. Negative net accumulated positions are assigned a value of zero. It is likely that many institutions hold positive amounts of these stocks and have only reduced the amount of their holdings over the previous year. The overweighting proxy might be a better measure of changes in portfolio weights than of the actual amount of these weights.

In summary, [Rose \(2009-this issue\)](#) and [Bethel et al. \(2009-this issue\)](#) provide interesting empirical results that raise many additional questions. From the Rose article, we learn that the relation between market value and staggered boards depends on outside blockholder ownership concentration. From Bethel et al., we learn that institutions actively buy control rights around merger record dates and that this activity negatively relates to total shareholder support for the merger. I am intrigued by these empirical findings, which serve as an impetus for additional research. Researchers can use these empirical results as starting points to motivate additional studies that will add to our understanding of the underlying causes and motivations for these observed phenomena.

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