Study Finds, for First Time, Data Boards Bundle Items for Votes

Securities Regulation & Law Report
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March 8, 2010

In a new study, two professors from Harvard Law School and the University of Southern California Gould School of Law are reporting that, for the first time, they have found empirical evidence that corporate management, to obtain outcomes it wants, bundles charter amendments that might be unfavorable to shareholders with measures that enjoy shareholder support.

The study, authored by Harvard's Lucian Bebchuk and USC's Ehud Kamar, reviewed the bundling of corporate mergers with a move to a staggered board structure. It used hand-collected data relating to governance changes in 393 public mergers occurring in companies of similar size from 1995 to 2007.

Opposed by Investors

Staggered boards—where directors are divided into three classes with staggered terms—are used by management as a key defense against hostile takeovers but generally are opposed by institutional investors. On the other hand, mergers generally are favored by shareholders if the deal increases value for the shareholders.

The study found that in mergers where the combined firm inherited the charter of one of the parties, the party with a staggered board was about 62 percent more likely than the other firm to become the combined firm. For mergers in which a new firm was formed (with a structure independent of the merging companies' charters), the new firm was significantly more likely to have a staggered board than the merging parties. According to the study, the mergers increased the incidence of staggered boards in new firms by about 31 percent, from about 58 percent to about 76 percent.

"Our results show that, in a significant number of cases, the adoption of a staggered board is due to bundling rather than to genuine shareholder support," the study said. Moreover, the findings indicated that bundling, which has been viewed as a "mere theoretical possibility," is actually "a real-world phenomenon that deserves attention."

"We show that managers have made significant use of their bundling power to get an economically meaningful increase in the incidence of staggered boards during a period in which shareholders have been opposed to this antitakeover protection," the study said. "Our results suggest that control of the corporate agenda enables management to obtain governance changes that could not be passed on a stand-alone basis."

Recommended Reforms

The study called for reforms to limit management's ability to "manipulate shareholder approval through bundling." One suggested reform was for courts to apply greater scrutiny to merger decisions and to mergers that are bundled with entrenching arrangements such as board staggering. The study, however, said its preferred approach was to allow shareholders to unbundle merger proposals by, for example, giving them the power to undo charter amendments that were introduced through bundling.

Bebchuk told BNA March 3 that enabling shareholders to “undo” the bundling—which he described as the “more meaningful and important reform”—can be done in a number of ways. “This is an area governed by state law, and we would like to see state law reformed on these issues,” he said.

For his part, Kamar agreed that “the natural place” to limit management's ability to use strategic bundling is in state corporation statutes. Kamar said that these days, state legislatures listen carefully to the market, and especially to institutional investors. He cited Delaware, for example, which in April made several pro-shareholder amendments to its corporation statute (41 SRLR 728, 4/20/09). “If institutional shareholders demand a sensible statutory reform to limit the use of strategic bundling, they may well get the reform they want,” he told BNA March 3. “In the meantime, state courts can at least scrutinize bundled stock mergers more closely than they do today. This requires no legislation.”

Bebchuk added that the study also has broader implications for all lawmakers, whether state law officials, the Securities and Exchange Commission, or Congress, who are interested in shareholder voting and shareholder approval requirements. “Our analysis suggests that such lawmakers be aware of bundling problems and should make sure that shareholder approval requirements are not circumvented through bundling.”

Among other observations, the study noted that in the 1970s through the mid-1980s, there was significant bundling activity involving dual-class recapitalizations. In such arrangements, shareholders are offered increased dividends in exchange for a new class of low-voting stock, in effect leaving management with higher voting stock and more control. A rule adopted in 1988 by the SEC to ban the practice was struck down by a federal court on the basis that the agency lacked authority for the rulemaking. However, in 1994 the SEC persuaded stock exchanges to include the bar in their listing requirements.

The study also suggested further review to determine whether bundling was a factor in other governance changes. The study is slated for publication in the May 2010 issue of the Harvard Law Review.