The Case Against Staggered Boards

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Here is a corporate governance puzzle to ponder.

Companies that are already public are rushing headlong to ditch their staggered boards. More evidence of this comes from the Harvard Law School Shareholder Rights Project.

At the same time, however, companies undertaking initial public offerings, like Angies’ List and LinkedIn, are increasingly choosing to go public with staggered boards. What explains this odd divergence?

The Shareholder Rights Project says it has submitted 87 board declassification proposals during the past proxy season. The project was subsequently able to enter into agreements with 41 Standard & Poor’s 500 companies committing them to bring management proposals to declassify their boards.

The results are stunning.

The project has succeeded in getting about a third of all the S.&P. 500 companies that had a staggered board to eliminate it.

The rights project is led by a corporate governance advocate, Professor Lucian A. Bebchuk, and a research fellow, Scott Hirst, both from Harvard Law School. The project has been working with five institutional investors — the Illinois State Board of Investment, the Los Angeles County Employees Retirement Association, the Nathan Cummings Foundation, the North Carolina Department of State Treasurer and the Ohio Public Employees Retirement System — to submit corporate-governance-friendly shareholder proposals.

The project has focused of late on eliminating staggered boards since they are particularly abhorrent to shareholder rights activists. In a staggered board, roughly a third of directors are up for election in any given year. It therefore takes two years to replace a majority of the board.

Academics argue that the staggered board thus serves as a powerful antitakeover device and “entrenches” the board, unduly protecting it from shareholder influence. Directors will instead look out for themselves and management instead of shareholders.

Academic research also lends some support to the questionable value of a staggered board. Companies with such boards have been found to have lower value, a greater likelihood of making acquisitions that are value-destroying, and a greater propensity to compensate executives without regard to whether they actually do a good job.

In fairness, there is also contrary evidence, and the value of the staggered board has yet to be determined definitively. At least one paper has found that shareholders of companies with staggered boards receive more consideration in takeovers than companies without such boards and that a staggered board does not significantly deter bidders.
The reason for this is intuitively obvious. Since a company with a staggered board is harder to take over, bidders must pay more to do so.

This debate is likely to continue for a long time, but in the meantime the opponents of the staggered board appear to have traction. The Harvard project’s announcement on Monday is another milestone in the general decline of the staggered board in public companies. According to the data provider FactSet SharkRepellent, 302 S.&P. 500 companies had staggered boards in 2002. Ten years later, the figure has fallen to 126.

Outside this universe of large companies, the staggered board has also fallen out of favor, though not as rapidly. Of 900 other companies outside the S.&P. 500, staggered board adoption rates have declined by about 25 percent since 2002.

It is here where our puzzle arises.

Compare this with the market for initial public offerings. According to FactSet SharkRepellent, 86.4 percent of the companies going public this year have had a staggered board. This figure is up from a still high 64.5 percent in 2011. Staggered board provisions have been adopted by prominent companies like Tesla, LinkedIn and Dunkin’ Brands.

What explains this divergence?

In the public markets, it appears that pressure from corporate governance activists like the Harvard project and from proxy advisory firms like Institutional Shareholder Services is working to coax companies into destaggering. Professor Bebchuk commented that a “main reason for the responsiveness is that annual elections are supported by a substantial majority of investors,” and that these shareholders tend to support destaggering proposals.

According to FactSet SharkRepellent, 448 proposals to destagger boards have appeared in proxy statements since 2005 and, on average, have received about 64 percent of votes in favor of the action. In other words, companies are bowing to the will of shareholders.

But since these companies are going along, it is natural to conclude that the companies most likely agree that eliminating the staggered board will provide value to shareholders.

If the staggered board is really so bad, though, then why are all of these companies going public with one? In fact, some of them, including LinkedIn and Bankrate, not only have a staggered board but have provisions requiring that 80 percent of all shares must subsequently vote to destagger the board. This provision is designed to directly contradict shareholder pressure to remove the board by making a winning vote on this matter extremely difficult.

Companies going public may believe that the staggered board is important because it creates value by insulating directors from shareholder pressure so that they can make long-term decisions. More cynically, they adopt these provisions because it prevents shareholders from having undue influence that may affect their ability to keep their management positions or pay themselves compensation.

In either case, companies are acting to adopt a staggered board before shareholder pressure comes to bear. In the I.P.O. market, most investors are there for short-term profits. They buy to almost
immediately sell on the first-day “pop” that often occurs. Corporate governance does not matter to these buyers.

But there may be another explanation here: the lawyers. The corporate legal bar is not particularly enamored of the staggered board, most likely from its experience representing companies without such a device. Many of these lawyers believe the staggered board provides negotiating room to bargain for a higher premium.

And when companies go public, at least one study has found that they are heavily dependent on their lawyers for advice on what antitakeover mechanisms to adopt. These companies are probably receiving legal advice to adopt a staggered board.

So is the advice the lawyers provide really what these companies want? The evidence in the aftermarket appears to be no.

But one thing is clear. These new companies with staggered boards are certainly giving new work to one constituency — Professor Bebchuk and his Harvard Law School Shareholder Rights Project.