Staggered Boards and Company Value

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A background issue in the battle between Airgas and Air Products and Chemicals is the effectiveness of staggered boards and what academic research has to bear on the issue.

Academics have speculated that the staggered board is an entrenching device. It makes a hostile takeover more difficult and protects underperforming management, reducing the value of the corporation.

If this theory is true, then you would expect the staggered board to result in a decrease in stock prices by companies adopting such a device. Without the fear of a takeover, companies with staggered boards would also be more likely to make bad decisions and be less willing to adjust exorbitant executive compensation. This is what studies have largely found.

However, while value may be reduced by the adoption of the staggered board, this reduced value may be exceeded by higher premiums that bidders may pay to overcome the stronger hostile defense. In other words, the reduction in value from a staggered board may be acceptable because shareholders reap the benefits of a higher premium in a takeover.

It is quite difficult to measure any additional premium a bidder might be paying in this respect. The most prominent study to do so provided mixed evidence. It found that companies with staggered boards do receive fewer takeover bids and have lower value, but they also receive higher premiums in takeovers.

The consequence is that the effect of staggered boards on corporations are still being debated and these studies are continuously criticized for being limited in scope and for failing to measure the market completely. Still, the academic community leans rather strongly toward labeling the staggered board as a problematic takeover defense. This leads to the oft-repeated criticism of academics by takeover law firms: What do they know about the real world? The staggered board dynamic appears to work effectively to raise value. Nonetheless, the staggered board is in retreat because of the efforts of the corporate governance movement in reliance on this academic research. According to Factset Sharkrepellent, 302 companies in the Standard & Poor’s 500-stock index had a staggered board in 2002. By 2009 the number had declined to 164.

The validity of the staggered board is not at issue in the Airgas dispute. Rather, the question in that litigation is how academics have historically viewed the device. Airgas cites a number of academic studies and form agreements; Airgas then claims that the authors of these studies and forms assumed that the staggered board involves a term of three years for each director. The authors of at least one prominent study have subsequently written that this was not their assumption.

In truth, the question has never really come up, and relying on these studies in any form is not going to get you anywhere. No one realized that there was an ambiguity in the Delaware corporate law statute allowing a company to adopt a staggered board until Jim Woolery and Min
Van Ngo at Cravath, Swaine & Moore spotted it. It is the classic example of having your keys in your hand while you search for them throughout the house thinking they are lost. You never notice what is there all along.

This back and forth on this issue in the debate over Airgas and Air Products also raises another chance to review these studies. Lucian A. Bebchuk, Alma Cohen and Charles Wang, professors at Harvard, have seized this opportunity.

In a study released on Wednesday, the professors examine how a Delaware Chancery Court decision in the Airgas dispute affected corporate value. The decision effectively permitted a hostile bidder to shorten the terms of a staggered board by moving up the date for the next annual meeting. If the Delaware Supreme Court upholds the opinion, Airgas will have to hold its shareholder meeting on Jan. 15, four months after the last one, in September.

The professors hypothesize that if the staggered board is indeed an entrenching device that unduly protects against takeovers, then the value of all companies with staggered boards would go up because of the Delaware decision. The reason is that they are now worth more since management is no longer as protected from its poor performance and the companies are easier takeover targets because of the ability of a bidder to move up the shareholder meeting date, as Air Products was able to do with Airgas.

The authors look at a sample of 2,631 public companies and do find this effect. In the wake of the Airgas opinion, companies with staggered boards rose in value by approximately half a percent, versus similar companies without a staggered board. The effect was more pronounced on those companies that were most affected by the decision. This includes companies that had their annual election in the second half of the calendar year. The authors state the reason why:

“Recall that the bylaw whose legality was approved by the Airgas litigation moves the annual meeting to January. Such a bylaw could substantially shorten the term of directors who would otherwise come up for re-election toward the end of the calendar year, but would have little practical impact on directors who would in any event come up for re-election early in the calendar year.”

Thirty-two percent of the companies with staggered boards in the authors’ sample had a meeting date later than June. The companies in this sub-sample outperformed the market by approximately 0.72 percent during a two-day period around the time of the Delaware decision.

There are issues with the study as the authors acknowledge. They state that the effects may be weakened “because (i) the market might have ascribed a positive probability to such a ruling and such expectations might have been already built into market prices prior to the ruling, and (ii) the bylaws rendered legal by the Airgas ruling reduce but not eliminate the ability of staggered boards to delay the removal of directors whose replacement is desired by a shareholder majority.”

But in both cases, these events would only work to diminish the results of this study. The evidence here thus supports the thesis that staggered boards diminish value.
The study is also tangentially relevant to the case of Airgas. The company’s arguments have shifted over time, but have occasionally encompassed part of the argument that Air Products would weaken the staggered board. Here, the market appears to agree with that.

As I have said before, the statutory issue is subsumed within the shareholder one. In other words, the Delaware statute on annual meetings is at best vague. Given the vote of the Airgas shareholders, their interpretation should govern as the lower court held. Shareholders should be permitted to define what the word “annually” means.

The Supreme Court hearing has shifted the market’s view of this. Airgas’s stock has declined in light of the tough and intelligent questioning of the justices at the appellate hearing on this case last week and the forceful arguments of Airgas’s counsel. The nervousness has been compounded by the wait for the opinion.

I always take these questionings with a grain of salt unless there is an obvious slant. But it is clear that the market has given its opinion in light of the decline in Airgas’s stock, although this may be in part a result of the overall weakening in arbitrage positions as the market heads toward the end of the year. And though the questioning of the justices makes me ever so slightly more inclined to see the possibility of a reversal, I still believe it is Air Products that will win on the strength of its legal arguments and the difficulty of enforcing the Airgas position. Are courts going to have to arbitrate every attempt by a company to move its meeting? The Airgas position seems to contemplate this.

Either way, as an academic I will be happy. The opinion will provide Professor Bebchuk and his co-authors and other academics with another event to measure the value of the staggered board.