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Revisiting a landmark study on shareholder rights and firm value: New research finds that only a number of corporate governance provisions really matter

Review of Bebchuk, L., Cohen, A., and Ferrell, A. (2009) "What matters in corporate governance?" *Review of Financial Studies*, 22 (2): 783-827.

Review by Robert Kropp. Published by the PRI Academic Network, February 2010.

Summary

A landmark study produced in 2003 by Gompers et al. used the 24 provisions of the corporate governance index compiled by the Investor Responsibility Research Centre in determining that companies with stronger shareholder rights have higher firm value. In an important follow-up to the Gompers study, authors Bebchuk, Cohen, and Ferrell of the Harvard Law School seek to determine if some of the IRRC provisions matter more than others. Focusing on the six corporate governance provisions listed by IRRC that were most often the target of shareholder resolutions, the authors find that only those six provisions affected monthly stock price returns, while the other 18 IRRC provisions had no effect.

Main practitioner findings:

- The Gompers study, which found that IRRC provisions on corporate governance had an effect on firm value, did not differentiate among the 24 provisions;
- In a new study, authors Bebchuk, Cohen, and Ferrell of the Harvard Law School identify the six corporate governance provisions listed by IRRC that were most often the targets of shareholder resolutions between the years 1990 and 2003;

- The authors found that firms with a low entrenchment index score—that is, those with stronger shareholder rights—are associated with statistically significant abnormal positive returns; and
- The authors emphasise caution in the development of corporate governance indices with large sets of provisions, warning that many are likely not to matter, and indeed could push firms in directions that are counter-productive.

Investigating the data on corporate governance compiled by the Investor Responsibility Research Centre (IRRC) and analysed by Gompers et al. in a landmark study on the relationship between shareholder rights and firm value, authors Lucian Bebchuk, Alma Cohen and Allen Ferrell of the Harvard Law School have produced a study suggesting that significantly fewer corporate governance provisions actually have a measurable effect on corporate stock prices.

Dividing the companies into ‘Democratic’ and ‘Dictatorship’ Portfolios, the Gompers study, published in 2003, analysed the effect on corporate stock prices based on the 24 corporate governance provisions listed by IRRC that appear beneficial to management, without differentiating among them. The study found that companies “with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions”, outperforming companies in the Dictatorship Portfolio by more than nine per cent per year from 1990 through 1998.

In their study, entitled ‘What matters in corporate governance?’ the authors generally concurred with the findings of the Gompers study. As with Gompers, the authors found that “corporate governance arrangements can substantially affect shareholders”. The authors took Gompers’ analysis a step further, by identifying the six corporate governance provisions listed by the IRRC that were most often targets of shareholder resolutions between the years 1990 and 2003.

The entrenchment index developed by the authors is based on six of the 24 IRRC provisions: Staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. According to the authors, “We include in this list of six provisions all the provisions among the IRRC provisions that have systematically drawn substantial opposition from institutional investors voting on predatory resolutions”. Four of the provisions seek to limit shareholder voting, while the other two—poison pills and golden parachutes—intend to prepare corporate management for hostile takeover bids.

Of the six provisions in the entrenchment index, staggered boards, golden parachutes, and poison pills were found by the authors to be the most common, with each present in a majority of the companies under study.

Each of the types of precatory resolutions chosen by the authors for the study’s entrenchment index was submitted at least 15 times during the 2003–2004 proxy season

and received a majority of shareholder votes in a majority of cases. According to the authors, “All the other eighteen IRRC provisions do not come even close to the above six IRRC provisions in terms of being the target of a significant number of opposing resolutions obtaining majority support among shareholders”.

Following Gompers, the authors use Tobin’s Q ratio to determine the value of the firms measured in their entrenchment index. The authors define Q as “equal to the market value of assets divided by the book value of assets”. In the Gompers study, it was found that going long on the Democracy Portfolio and short on the Dictatorship Portfolio led to significant abnormal returns. However, when the analysis was extended to those companies in the middle of the Gompers index distribution, no statistically significant abnormal returns were noted.

In the study by Bebchuck et al., the authors found that, “Firms with a low E index score are associated with statistically significant abnormal returns both during the 1990–1999 period investigated by Gompers...and the longer 1990–2003 time period” covered by the later study. Furthermore, even companies in the middle of the entrenchment index distribution generated positive monthly abnormal returns, although smaller than those companies with extreme entrenchment index scores.

The authors found also that “the corporate governance provisions not included in the entrenchment index have no explanatory power” in either of the two time frames studied. In fact, according to the authors, the six provisions included in the entrenchment index “fully drive the findings documented by prior research that the IRRC provisions in the aggregate are correlated with Tobin’s Q, as well as returns during the 1990s”.

While the authors provide evidence that entrenching provisions bring about or help maintain lower firm valuation, they acknowledge that their findings do not establish causality, and maintain that more study needs to be done. The authors further acknowledge that the high entrenchment levels of companies with low Tobin’s Q ratio scores could help them prevent hostile takeovers.

However, the findings of their study do allow the authors to conjecture that the four provisions associated with shareholder power do bring about lower firm value, while the correlation between those provisions designed to defend against hostile takeovers and lower firm value reflects the tendency of managers of companies to take such steps.

The authors conclude their study by warning against “kitchen-sink” approaches of building corporate governance indices that are even larger than that of the IRRC. The study states, “In any large set of governance provisions, many are likely not to matter or to be an endogenous product of others”.