The Ethical Implications of Ignoring Shareholder Directives to Remove Antitakeover Provisions

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ABSTRACT

Managers have a unique fiduciary responsibility to shareholders of a firm that implies a set of ethical obligations. At a minimum, managers are required to protect shareholder's interests when other stakeholders are unaffected by their decision. This ethical imperative has been established in the literature. Two specific cases where managerial actions have been argued to be unethical are the adoption of classified boards and poison pills. In cases of conflicts of interest between managers and shareholders, the board of directors of the firm has an ethical obligation to shareholders. The structure of the board can affect its ability to fulfill this obligation. In this study, we empirically analyze the role of board structure in protecting shareholder rights in the specific case of antitakeover provisions. We test this question on a sample of firms whose shareholders have voted to remove antitakeover provisions and find that independent, focused boards are more likely to accede to shareholder resolutions than are less independent boards. Board size is also important and related to other board structures. We draw implications of this finding for future research on the ethics of board governance.

"What's really needed is a change in mindset – one that fosters not only a culture of compliance but also a company-wide environment that fosters ethical behavior and decision-making."

William H. Donaldson, SEC Chairman (2004)

INTRODUCTION

Recent corporate scandals have highlighted the extent of managerial abuses of shareholder trust. These abuses have resulted in extensive financial and social damage. The ensuing public outcry for increased accountability and ethical behavior has led to growing emphasis on corporate governance as a mechanism to bring about desired managerial behavior. Much of this debate has centered on the role governance plays in ensuring that managers fulfill their fiduciary responsibilities to their shareholders. The purpose of this paper is to focus on the ethical dimensions of the managerial decision to enact shareholder initiated and supported proposals to remove potentially damaging antitakeover provisions from the firm's bylaws and to empirically investigate the structure of firms that enact or fail to enact these passed proposals.

The fiduciary role of managers and the board of directors of a firm and the ethical and moral obligations they have to shareholders has been an important topic of theoretical research and debate in the ethics literature since its inception. Freeman's (1984) book on stakeholder theory and the role of various stakeholder relationships in a firm laid the foundation for this discussion. Although some researchers have advocated that firm executives have fiduciary responsibilities towards multiple groups of stakeholders, most agree that managers and top executives, at a minimum, have a fiduciary duty to shareholders of the firm. Indeed, several scholars have argued that shareholders have a special status among the different stakeholder groups to whom managers have a fiduciary duty. For example, Boatright (1994) argues that the public policy benefits of keeping executives focused on a single goal like shareholder value grants shareholders a special right among the different stakeholders. Davis and Thompson (1994) conclude that managers have an obligation to work in the best interests of shareholders, and Goodpaster (1991) and Goodpaster and Halloran (1994) support this claim and suggest that the duty to stockholders supersedes those of other constituencies. David, Bloom, and Hillman (2007) examine managerial responsiveness to shareholder proposals and argue that while managers are not legally obligated to implement the proposals, they have a fiduciary responsibility to their shareholders.

Managerial responsiveness to shareholder proposals is relevant to many Americans today as the American Shareholders Association reported that 50% of households in the U.S. and 70% of voters own shares of stocks. Shareholders expect managers, as their fiduciaries, to make decisions that are in shareholders' best interests. Indeed, some researchers including Davis and Thompson (1994) conclude that managers have an obligation to do this. Our study examines the ethical implications of managers ignoring directives from shareholders to remove antitakeover provisions. More specifically, we examine whether governance mechanisms that entrench management impede responsiveness to shareholder initiatives.

The remainder of the paper is organized as follows. In the next section, we review the ethical underpinning of corporate governance and managerial responses to initiatives by shareholders. In the following section, we develop our hypotheses related to the impact of board structure and composition on the likelihood of firms' adopting shareholder initiatives to limit antitakeover defenses. We then discuss our data, methods and report our results. Finally, we discuss the implications of our findings for future research and practice on the ethics of governance.

THE ETHICS OF ANTITAKEOVER PROVISIONS

Building on Freeman's (1984) classic argument of the importance of a stakeholder perspective in corporate strategy, subsequent research has employed stakeholder theory as a frame to examine the ethical implications of a firm's actions as they relate to responsiveness to different classes of stakeholders, including shareholders. Boatright (1994) argues that shareholders have claims that supersede those of all other stakeholders. Goodpaster (1991), Goodpaster and Halloran (1994), and Davis and Thompson (1994) go beyond the claims of Boatright and suggest that managers have an obligation to work in the best interests of shareholders that surpasses their obligations to all other firm stakeholders.

Marens and Wicks (1999) discuss the role of the court system in this area, stating that the courts have established the importance of this fiduciary responsibility to protect shareholders from self-dealing by directors and managers. This self-dealing could exist in the form of expenditures made to benefit top management or their friends as described in the classic literature on the theory of the corporation and managerial obligations (Bearle and Means, 1933). Marens and Wicks (1999) claim that more recently this self-dealing has manifested itself in areas that relate to managerial entrenchment. The authors give a modern application of this self-dealing as one in which managers and directors keep shareholders from voting at a tender offer because the inside directors fear for their jobs.

Marcoux (2003) speaks of the idea of moral obligation and argues that shareholders have two vulnerabilities to executives that substantiate these individuals as their fiduciaries. Shareholders have control vulnerability to managers because they give their assets over to someone who is acting as their fiduciary. They also have information vulnerability to firm executives as managers and directors have access to information about the shareholder's situation of which the shareholder may be unaware. Marcoux concludes that the presence of these vulnerabilities in the shareholder/executive relationship establishes the executives' moral responsibilities to their investors. In a later study, Williams and Ryan (2007) agree with Marcoux that executives have moral obligations to their shareholders in the form of fiduciary responsibilities and state that managers should be partial to shareholder interests.

David, Bloom, and Hillman (2007) examine the responsiveness of managers to shareholders' proposals, specifically as it impacts corporate social performance. Although corporate social performance is not at issue in our study, their discussion on the responsiveness of managers to shareholder proposals is most relevant. The authors discuss the impact of shareholder proposals and mention that managers must be aware that the proposed actions may impact other firm stakeholders. They also argue that while managers are not legally obligated to implement the proposals, they do have a fiduciary responsibility to their shareholders. While it may not be in the best interests of shareholders or the firm for managers to implement all proposals, David, Bloom and Hillman claim that the proposals are alerting managers to an underlying problem and a need for possible change.

A series of corporate meltdowns at the end of the 20th century and beginning of this century brought the manager/shareholder relationship and the role of corporate governance in enforcing the moral tenants of the relationship into sharper focus. The recent spate of corporate malfeasance has led researchers and policymakers to increase their efforts with respect to best practices in governance. Sarbanes-Oxley is one specific regulatory attempt to modify corporate behavior. The intent of Sarbanes-Oxley is to positively impact corporate behavior and, hopefully, lead to improved ethical behavior on the part of top level managers and improved oversight by the firm's board of directors.

Schwartz, Dunfee, and Kline (2005) discuss the importance of the role of the board of directors in ensuring the success of any significant legislative reforms. Specifically, Schwartz, et al. (2005) conclude that the ethical roles of the firm's top management team are critical and ultimately lead to actions that are in the best interests of the firm in the long run. Further, Arjoon (2005) concludes that legislating ethical behavior is unrealistic and cites Donaldson (2003) who indicates that ethical obligation on the part of the firm cannot be achieved through legislation alone. Therefore, Sarbanes-Oxley may not be enough to lead managers to act ethically.

One form of managerial action not addressed in Sarbanes-Oxley is the incentive managers have to entrench themselves or, more specifically, to protect their jobs through the process of fighting potential value creating takeovers. Managers can use takeover defenses such as classified boards and poison pills to avoid being taken over, thereby reducing the chance that they will lose their jobs.

The merger wave of the early 1980s spurred the mass adoption of antitakover amendments. The debate over the value impacts of these devices and whether or not they represented shareholder interest soon followed. Specifically, the ethics of antitakeover provisions is questioned because the rationale for using takeover defenses is not always clear. Managers argue that they use the defenses in an ethical manner since takeover defenses imbue them with bargaining leverage to obtain a higher price for shareholders in the event of a takeover. The opposing argument is that takeover defenses entrench managers by not allowing exposure to the market for corporate control, leaving them less accountable to shareholders.

The earliest studies of the wealth effects of takeover defenses and the determinants of adopting these measures were completed following the 1980s merger wave with no clear conclusion as to their effect on managerial behavior or the relationship between managers and shareholders. (Deangelo and Rice, 1983; Linn and McConnell, 1983; Jarrel and Poulsen, 1987; Ryngaert, 1988; and Sundaramurthy, Rechner, and Wang, 1996). In a survey of the early studies in the area, Meade and Davidson (1993) conclude that two specific antitakeover provisions are clearly unethical and a violation of manager's fiduciary and legal responsibility to investors. These two provisions are classified board and poison pill defenses. Meade and Davidson single out these two provisions because classified boards and poison pills were found to destroy value and had no clear benefit for other stakeholders of the firm.

More recent research has focused on poison pills and classified boards in the broader context of corporate governance. The literature criticizes the existence of these measures and concludes that strong takeover defenses are likely to entrench managers and destroy shareholder wealth (Sundaramurthy, 2000; Bebchuck, Coates IV, and Subrammanian, 2002; Gompers, Ishii, and Metrick, 2003; Bebchuk and Cohen, 2005; and Brown and Caylor, 2006). Specifically, these recent studies find that firms with classified boards and poison pills have significantly lower valuations than firms with less entrenched management. Faleye (2007) provides a comprehensive study on the sources of value destruction for classified board provisions. Faleye finds that firms with classified boards have more entrenched management and less effective boards than firms without classified boards. Firms with classified boards have lower CEO turnover, higher executive compensation and are generally less responsive to shareholders than their peers without classified boards.

Our study focuses on the two specific takeover defenses whose implementation has been found to be unethical. Poison pills represent a class of shareholder rights plans that make it prohibitively costly for a firm to be taken over without managerial approval. Poison pill provisions do *not* require shareholder approval for adoption (Bizjak and Marquette, 1998). An antitakeover charter amendment known as a classified board election is the second type of takeover defense examined in this study. The charter amendment *does* require shareholder approval for adoption (Bebchuk, 2005). Classified board elections make the process of taking over a company through a proxy fight a much lengthier procedure due to the small number of board members elected in any one year. Regardless of whether these antitakeover provisions need shareholder approval, the very presence of the provisions has been found to be unethical (Meade and Davidson, 1993). This study focuses on a sample of firms where a majority of shareholders vote to rescind poison pills and classified board elections.[1]

In light of recent corporate ethical lapses, shareholders are more aware than ever that managers may be acting unethically by trying to protect their own interests instead of taking action in shareholders' best interests. Therefore, shareholders of many firms have made proposals at the annual meeting to remove poison pills and classified board provisions. Hebb

(2006) examines pension funds and their role as activists in the firm. She finds that pension funds have increasingly focused on removing provisions that entrench managers and improving the transparency of the firm. Hebb uses interviews with the California Public Employees Retirement System (CalPERS) to determine the focus of activist investors. She finds that CalPERS focuses on the removal of antitakeover provisions because of their strong belief that these provisions destroy shareholder value. This view is bolstered by recent evidence provided in Bebchuk and Cohen (2005), Brown and Caylor (2006), and Gompers, Ishii, and Metrick (2003).

The theory and evidence clearly supports the contention that classified boards and poison pills are value destroying mechanisms that entrench managers and hurt the shareholders to whom managers owe a fiduciary responsibility. Our study focuses on a sample of firms in which a majority of shareholders have voted to remove either a classified board or a poison pill provision. For each firm event in the sample, the vote in favor of removing the provision exceeds 50% of shares outstanding. The group of firms is selected to remove any doubt concerning the wishes of the shareholders. Shareholder proposals rarely receive majority approval so our sample represents a case of shareholders sending a strong signal to management.[2]

The remainder of the current study examines the role of governance structure when managers choose to ignore the directives of shareholders to rescind antitakeover provisions. Since managers are not bound to act on shareholder proposals to remove takeover defenses even if a majority of shareholders support the removal, many firms in our sample act unethically and choose to maintain the provisions even in the face of overwhelming shareholder sentiment to remove them. The results of this study will provide evidence on how different governance structures affect the way management fulfills its moral and ethical fiduciary responsibility with respect to the shareholders of the firm. We will examine two aspects of governance, the composition and structure of the board and the ownership structure of the firm to determine how these important governance mechanisms impact the probability that managers respond ethically to shareholder votes to rescind classified board and poison pill takeover defenses.

THE ROLE OF CORPORATE GOVERNANCE IN THE IMPLEMENTATION OF PASSED PROPOSALS

Hosmer (2000) describes the need for basic empirical research that supports business ethics theory. In this study, we provide empirical evidence on the relation between a firm's governance structure and the likelihood that the firm's top level managers will act ethically and follow shareholders' directives to remove the antitakeover provisions.[3] Rechner, Sundaramurthy, and Dalton (1993) find that governance plays a role in the likelihood of adoption of antitakeover measures. The likelihood that managers will enact shareholder proposals to remove poison pills and classified board provisions should be directly related to the strength of internal governance mechanisms. Our sample consists of firms whose managers face a clear conflict. Keeping antitakeover provisions in place benefits them by making their job more secure. These provisions clearly do not benefit shareholders, and thus in our study, the decision by managers to retain the provisions is deemed to be unethical. Corporate governance mechanisms are meant to mediate this type of agency problem between managers and shareholders.

Previous research on governance quality focuses on two main areas, board composition and ownership structure. Composition of the board, including the characteristics of board size, independence, and director attributes has been found to impact the ability of directors to operate as champions for shareholder rights. A well-functioning board oversees management and ensures that they operate in the best interest of shareholders. Firms with strong boards should be more likely to follow the directives of shareholders. The second main focus of corporate governance research focuses on the ownership structure of the firm. In our study, the variables we include that relate to ownership structure are share holdings of managers, directors, and large blockholders. Research related to these corporate governance mechanisms follows in the next two sections.

Board size and composition

The first governance characteristic that we examine is board size. The size of the board has been found to impact the board's ability to oversee management. Arguments have been made in support of both large and small boards. One advantage of larger boards relates to the firm's ability to coordinate with other firms to obtain vital resources (Goodstein, Gautam and Boeker, 1994; Dalton, Daily, Johnson and Ellstrand, 1999; Daily, McDougall, Covin and Dalton, 2002; Hillman and Dalziel, 2003; and Dalton and Dalton, 2005). Additionally, Williams, Fadil and Armstrong (2005) provide evidence that the incidence of illegal activity is reduced in firms with larger boards. Dalton, Daily, Johnson, and Ellstrand (1999) also find that larger boards are more effective.

Alternatively, others argue that smaller boards are more focused and are therefore better able to monitor the firm's top level managers (Lipton and Lorsch, 1992 and Firstenberg and Malkiel, 1994). Further, Yermack (1996) found an inverse relation between board size and firm value and concludes that smaller boards are more effective than larger boards. Finally, Boone, Casares-Field, Karpoff, and Raheja (2007) provide evidence that board size and independence are shaped by an extensive combination of firm-specific and managerial characteristics. They conclude that board composition is an endogenous result of a competitive process. That is, most firms' boards are tailored to suit their unique competitive environment. The extensive body of evidence related to board size clearly indicates that board size plays an important governance role for firms. The diverse empirical results lead us to hypothesize that the size of the board will have an effect on the likelihood the board will act ethically and remove a classified board or poison pill takeover defense that a majority of the firm's shareholders have voted to rescind. However, the impact of board size will be different depending on other control structures in place. Boone, Casares-Field, Karpoff, and Raheja find that size and board independence are related. The importance of board size and the potential interaction between size and independence lead us to propose the following two hypotheses:

Hypothesis 1a: The size of the board of directors is related to the likelihood that proposals to rescind antitakeover defenses are enacted.

Hypothesis 1b: The effect of board size on the probability of enacting the proposal to rescind is influenced by the independence of the board of directors.

The composition of the board of directors is another important factor in the quality of board monitoring. The board composition focuses on the mix of insiders and outsiders on the board. Theoretically, higher independent outside director[4] representation leads to stronger oversight by the board (Brickley, Coles, and Terry, 1994; Bacon, Cornett, and Davidson 1997; McWilliams and Sen, 1997; Sundaramurthy, Mahoney, and Mahoney, 1997; Rindova 1999; Pitcher, Chreim and Kisfalvai, 2000). Stronger board oversight increases the likelihood that the firm will act ethically. Conversely, boards that are controlled by insiders are likely to make decisions consistent with managerial incentives as opposed to shareholder incentives. Hillman and Dalziel (2003) model the relation between board composition, resource dependence, and board monitoring and suggest that independent boards are more effective. Sundaramurthy, et al.

(1996) find that insider dominated boards are more likely to adopt antitakeover provisions than outsider dominated boards. Driscoll (2001) argues that independent boards are more likely to provide ethical leadership relying on experience as a director in the mutual fund industry to support her arguments. Given the consistency of the arguments in prior research, we believe that higher proportions of independent outside directors on the firm's board will lead to better managerial oversight. Firms with insider dominated boards will be more likely to side with management when there are conflicts of interest. We define a board as dominated by independent outsiders when greater than 80% of the directors are independent outsiders.[5]

Hypothesis 2a: The extent to which a board is dominated by independent outside directors is directly related to the probability that proposals to rescind antitakeover defenses are enacted.

Hypothesis 2b: The extent to which a firm is dominated by boards controlled by insiders is inversely related to the probability that proposals to rescind antitakeover defenses are enacted.

In addition to the independence of the board, other characteristics of directors have been found to be important in determining the quality of the board. The tenure of outside directors is one such director characteristic. Vafeas (2003) analyzes the relation between tenure and outsider independence and finds that long-tenured board members align themselves with management at the expense of shareholders in the specific case of CEO compensation, which is consistent with arguments presented by Lawler and Finegold (2005). Vafeas argues both positive and negative attributes of length of tenure. In contrast to the negative effect director tenure may have on shareholders, Davidson, Pilger and Szakmary (2004) report longer tenure of outsiders on the board has a positive effect on the market's reaction to poison pill adoption. This indicates that the market feels tenured outsiders are more likely to counteract insider entrenchment. In the current case, the bargaining strength that outsider directors obtain through time will outweigh the potential alignment of outside directors and management, increasing the likelihood that top executives will be pressured to make ethical decisions. We consequently hypothesize:

Hypothesis 3: The tenure of outsiders on the board is directly related to the probability that proposals to rescind antitakeover defenses are enacted.

Another recent issue that has been addressed in the literature relates to the number of boards on which independent directors serve. It is common for directors to serve on more than one board. Lawler and Finegold (2005) argue that board members' workloads are increasing over time. For individuals that serve on more than one board, an increase in director workload can have enormous implications making it unlikely that the director can perform effectively on any. Specifically, Fich and Shivdasani (2006) find that boards where outsiders have three or more directorships are associated with poor corporate governance. Busy directors do not fulfill their role as monitors for shareholders. Perry and Peyer (2005) discuss the role that the number of directorships held by outsiders play in the effectiveness of outside directors. Perry and Peyer find that in poorly governed firms, high numbers of directorships by outsiders is undesirable. In addition, both National Association of Corporate Directors and the Council of Institutional Investors recommend limiting directorships to three for outside directors. These arguments suggest that "busy" outside directors may be less able to monitor managers and may have fewer incentives to fight management when they are employed on multiple boards. The recent evidence on the ineffectiveness of busy independent outside board members leads to our next hypothesis:

Hypothesis 4: The number of directorships held by independent outside directors is inversely related to the probability that proposals to rescind antitakeover defenses are enacted.

Ownership Structure

The ownership structure of the firm is also related to the quality of governance. If there are strong, motivated shareholders, they can have an impact on the agency problem. Large blockholders have greater incentive to monitor management (Bizjak and Marquette, 1998). If a firm has a large portion of its shares owned by a few shareholders, managers will be more likely to yield to shareholder decisions. If shareholders are smaller and more diverse, management might ignore shareholder wishes to strengthen its own position. Further, isolated, diverse shareowners are less likely to form a consensus regarding managerial actions the way that larger more cohesive blockholders can, increasing the likelihood of bringing pressure to bear on mangers to act ethically.[6]

Shliefer and Vishny (1986) find that large shareholders can mitigate agency problems between managers and shareholders. Ryan and Schneider (2002) argue that it is investor activism that influences managerial behavior, and suggest that activism is a function of many things, including the percentage of firm share ownership (Smith 1996; Carleton, Nelson and Weisbach 1998; Del Guercio and Hawkins 1999). Ryan and Schneider indicate that institutional activists use their firm shareholdings to influence the firm's strategic direction and performance by voting proxies to counter managerial positions that they feel may be destroying firm value. While Ryan and Schneider suggest that not all institutional investors become activists, we argue here that institutional investors will, at a minimum, use their voting power, as suggested by Shleifer and Vishny (1986), to mitigate the agency conflict between managers and shareholders and influence firms to rescind classified board and poison pill takeover defenses. Therefore we propose:

Hypothesis 5: The percentage of shares owned by large blockholders is directly related to the probability that proposals to rescind antitakeover defenses are enacted.

The share ownership of the firm's board members should also play a role in the responsiveness to shareholder votes on proposals to rescind takeover defenses. Numerous authors have put forth arguments establishing the use of share ownership to align executive and non-executive board member incentives (examples include Jensen and Murphy, 1990; Dalton and Daily, 1999; Hambrick and Jackson, 2000; Sundaramurthy and Lewis, 2003). Specifically, CEO ownership has both incentive alignment and entrenchment effects. Claessens, Djankov, Fan, and Lang (2002) find that CEO ownership dominates managerial ownership in decision making and that the impact of CEO ownership on value is non-linear as in some cases, the entrenchment effects destroy value and outweigh the benefits from alignment. Other research that spoke of the entrenchment effects associated with poison pills and/or classified boards include Sundaramurthy, 2000; Bebchuck, Coates IV, and Subrammanian, 2002; Gompers, Ishii, and Metrick, 2003; Bebchuk and Cohen, 2005; and Faleye, 2007. For our sample, we expect the entrenchment effects to dominate the incentive effects as CEOs are the ones who initially implemented the antitakeover provisions resulting in their entrenchment in the firm. Firms with entrenched CEOs that have a high level of ownership should thus be unlikely to pass shareholder proposals as they protect both their personal and financial capital leading to the following hypothesis:

Hypothesis 6: The percentage of shares owned by the CEO of the firm is inversely related to the probability that proposals to rescind antitakeover defenses are enacted.

While CEO ownership levels are related to both entrenchment and incentive effects, ownership levels for both inside and outside board members provide incentive for board members to align themselves more closely with shareholders. Several previous studies have found that board ownership has a positive effect on the shareholder wealth effects of antitakeover measures and the perceived responsiveness of boards to shareholder issues (examples include McWilliams, 1990; Brickley, Coles, and Terry, 1994; Bacon, Cornett, and Davidson, 1997; and McWilliams and Sen 1997). More recently, Dalton, Daily, Certo, and Roengpitya (2003); Dalton and Dalton (2005); McNulty, Roberts, and Stiles (2005); and Shen (2005) discuss the benefits of aligning incentives through board share ownership. A summary of these studies suggests that independent outside directors are likely to improve their monitoring when they are shareholders themselves. Driscoll (2001) discusses the best practices document from the mutual fund industry which suggests that directors should be owners to improve their ethical performance. The preponderance of previous empirical and theoretical arguments leads to the following hypotheses:

Hypothesis 7a: The percentage of shares owned by inside directors is directly related to the probability that proposals to rescind antitakeover defenses are enacted.

Hypothesis 7a: The percentage of shares owned by outside directors is directly related to the probability that proposals to rescind antitakeover defenses are enacted.

METHODS

Sample

We use The Investor Responsibility Research Center's (IRRC) published database from 2000 and 2004 to obtain a sample of firms voting on shareholder proposals during the period January 1990 through December 2003. We identify firms with shareholder proposals to rescind poison pill and classified board provisions.

We divide our sample into two subsets. One subset consists of firms where managers act in accordance with shareholder wishes and the provision is removed, and the other subset consists of firms where managers ignore the directive from shareholders and retain the provision. Given the earlier discussion, the managers of the second subset of firms have clearly violated their fiduciary responsibilities and their actions are unethical.

There are 207 proposals to repeal classified board provisions and rescind poison pills during 1990 through 2003 that are approved by shareholders and enacted by managers. Conversely, 74 proposals are identified where the shareholders approve the removal of the takeover defense and managers fail to act on the shareholder proposal. Table 1 summarizes the sample by year and type.

Empirical Analysis

We perform a logistic regression to model the relation between the independent variables described below and the probability that the firm will remove the takeover defense once shareholders have voted to rescind the defense. In this model, the dependent variable is the dummy variable measuring the implementation of the passed proposals. The fact that the dependent variable is binary leads to the use of the logistic model. We also model the potential interaction of some of the independent variables and the possibility that the relation between the dependent variable and independent variables may be non-linear in some cases.

For the dependent variable, a dummy variable is created to measure the implementation of passed measures and is equal to one if the takeover defense is removed in firms that passed the proposal and zero if the defense is not removed. This binary variable will be used as the dependent variable in tests of the determinants of shareholder proposal outcomes.

The independent variables in the model measure the strength of the internal controls, or governance characteristics, of the sample firms and are used in the logistic regressions to examine our hypotheses. We measure board size as the total number of board members for each firm. In addition to the size variable, we include an interactive term that measures the role of board size in firms whose boards are dominated by independent outsiders. The interactive term is created by multiplying the size variable by a dummy variable measuring independent outsider dominated boards. This interactive term measures the marginal impact of size in firms with strongly independent boards.

Two dummy variables are included to represent the composition of the board as it relates to both inside and outside directors and also to incorporate the potential non-linear impact of outside representation on the board. The dominance of independent outside directors is modeled using a dummy variable which is equal to one if the percentage of independent outside directors on the board is greater than 80% and zero otherwise. Insider control is modeled using a dummy variable equal to one if the percentage of insiders on the board is greater than 50% and zero otherwise.

Another independent variable used in the model is tenure which is measured as the average tenure of each of the independent outside directors. The average number of boards served on by outside directors is another variable included in testing. It is calculated as total board memberships outside of the sample firm divided by the number of independent outside directors.

Four ownership variables are created to measure the ownership of key constituencies. Blockholder ownership is measured as the percentage of shares owned by non-director blockholders with greater than 5% ownership stake in the firm.[7] CEO ownership is measured as the percentage of shares outstanding owned by the CEO of the firm. Insider ownership is measured as the percentage of shares outstanding owned by inside directors and outsider ownership is measured as the percentage of shares outstanding owned by the independent outside directors.

Finally, four control variables are created. A cursory examination of the data reveals that the probability of implementing passed proposals has increased through time. There is an obvious change in this probability after the implementation of Sarbanes-Oxley. In order to ensure that our model does not simply measure this difference in probability through time we include a control variable. The Sarbanes-Oxley dummy is a dummy variable coded as 1 if the proposal occurs after the passage of Sarbanes-Oxley and zero if it occurs prior to the passage of Sarbanes-Oxley. The second control variable is used to differentiate between classified board proposals and poison pill proposals. The data show that poison pill proposals are more likely to be implemented than classified board proposals. In order to account for this difference in the model, a classified board dummy is created. This dummy variable is coded as 1 if the proposal is to rescind a classified board provision and zero if it is to rescind a poison pill.

Another control variable is included to account for other antitakeover measures the firm has in place. Gompers, Ishii, and Metrick (2003) create an index that measures the number of antitakeover provisions firms have in place. They call this measure the G-index. We use a firm's G-index score to control for antitakeover measures other than the sample specific measures we are examining. Finally, we include firm size to account for the possibility that our results are driven by firm specific characteristics outside of the governance measures in our model.

RESULTS

Means, standard deviations and Spearman correlation coefficients of governance variables for the full sample are presented in Table 2. None of the variables have correlation coefficients above 0.23. The correlations for most of the variables are well below 0.1. These results provide reassurance that multicolliniearity should not be a problem in our logistic model estimation. Some other interesting results from our sample include the fact that over 35% of the boards in the sample are dominated by independent outside directors while only 7% are controlled by inside directors. These results support the trend toward director independence but also indicate that many of the boards fall far short of the current call for strongly independent boards

The core of the empirical results for this study can be found in Table 3. The results of the logistic model estimation presented in Table 3 provide evidence into how the governance terms interact to determine the likelihood of implementation of passed proposals. The model is estimated using the controls, board structure, and ownership variables. The parameter estimates for the models represent the strength of the linear relationship between the independent variable and the probability of implementation of a passed proposal.

The results from the logistic model estimation are consistent with several of the hypotheses. The Chi-Square for the model as a whole is 106.01. This result indicates that the model is significant at beyond the 0.0001 threshold showing there is a strong linear relationship between our binary dependent variable and our explanatory variables. The parameter estimate for board size is positive and significant at the 1% level. Further, the parameter estimate for the board size outsider domination interactive term is negative and significant at the 1% level. These two results taken together are consistent with Hypothesis 1. Size is significantly related to the probability passed proposals are implemented and the role of size is influenced by other board structures, specifically by whether or not the board is dominated by outsiders. For firms in our sample with boards that are not dominated by independent outside directors, larger boards were more likely to implement passed proposals. For firms in our sample with boards that are dominated by independent outside directors, smaller boards are more likely to implement passed proposals.

The next two parameter estimates relate to Hypothesis 2a and 2b. The outsider domination dummy is positive and significant at the 5% level. This is consistent with Hypothesis 2a which argues boards that are dominated by independent outsiders are more likely to force implementation of passed proposals. However, the parameter estimate for the inside control dummy is not significant as hypothesized in 2b.

The parameter estimate for the outside tenure variable is not significant. This is inconsistent with Hypothesis 3 which argues the longer tenured outside directors will have more clout and increase the likelihood that passed proposals are implemented. The parameter estimate for the directorships held by outside directors is negative and significant at the 1% level consistent with Hypothesis 4. Busy outside directors will be less likely than more focused directors to provide proper monitoring of managers and thus less likely to force implementation of the passed proposals in the sample.

The final four variables are used to test Hypotheses 5, 6, and 7. The parameter estimate for the blockholder ownership variable is not significant. This is inconsistent with Hypothesis 5 which argues that large blockholders will have bargaining power with managers and will be likely to force management to implement passed shareholder proposals. Consistent with Hypothesis 6, the parameter estimate for the CEO ownership variable is negative and significant at the 5% level. CEOs with high ownership levels will be more entrenched than other CEOs and less likely to acquiesce to shareholder wishes in the sample firms. The parameter estimates for the insider and outsider ownership variables are insignificant. These results are not consistent with either Hypothesis 7a or 7b.

DISCUSSION

Our findings support the general contention that governance structure has important implications for the relationship between management and shareholders. Managers have a fiduciary responsibility to the shareholders of the firm and should act in their best interest when other stakeholders are unaffected. Poison pills and classified boards have been shown to destroy firm value and do not benefit non-shareholder stakeholders. These provisions do provide managers insulation from external control markets and provide them with benefits that do not accrue to shareholders. In cases such as this where there is a conflict of interest between managers and shareholders that keeps managers from fulfilling their fiduciary responsibility, it is the role of the board of directors to act as champions for the shareholders. Management works for the firm's owners and these v TD0lderer T006u3495 0 TD-0.0001 Tc330901 Twi andsta govto f

This result implies that while CEO ownership might align shareholder and managerial interests, it can also entrench current management leading to conflicts of interest in takeover contests.

Our study uses a unique sample to provide evidence on the role that governance plays when there are conflicts of interest between managers and shareholders. The sample firms have all voted to remove antitakeover provisions that have been shown to be unethical and destroy shareholder value without improving conditions for other stakeholders of the firm. The managers of these firms have a fiduciary responsibility to the shareholders to remove these unethical devices, possibly at their own expense. A portion of the firms in our sample fail in this duty. We provide evidence consistent with the argument that governance structure plays an important role in insuring that management fulfills its fiduciary obligations towards shareholders. We must take care in generalizing our results to broader issues but the results do support other research concerning governance effectiveness. This study can add to a growing body of empirical research on what works in governance.

CONCLUSION, IMPLICATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

Recent corporate scandals that involve managerial abuses of shareholder trust have highlighted the issue of the fiduciary responsibility of firm executives toward their stakeholders. Building on Freeman's (1984) work in the area of stakeholder theory, we use a body of literature that speaks to the issue of when managers have a fiduciary responsibility to the owners of the firm. Our current research question has its foundation in this literature. Goodpaster (1991), Goodpaster and Halloran (1994), and Davis and Thompson (1994) all conclude that managers have a fiduciary responsibility to shareholders that supersedes those of other constituencies and that they have a duty to make decisions that are in the best interests of shareholders.

Using this as a basis for our empirical inquiry, we examine the ethical implications of managerial decisions to ignore shareholder directives to remove value destroying antitakeover provisions. Literature, including Meade and Davidson (1993), shows that the removal of these antitakeover provisions does not damage other firm stakeholders. Thus, we argue that it is unethical for management to ignore shareholder supported proposals to remove these value destroying provisions. Our empirical findings suggest that specific characteristics of the board of directors and the ownership structure of the firm make it more likely that managers will accede to the wishes of shareholders.

We find that boards dominated by independent outsiders have a higher probability of implementing passed proposals than less independent boards, and that busy directors are associated with poor governance and are not strong monitors of managers. Results also indicate that when the CEO of a firm owns a large percentage of shares, managers are less likely to implement passed proposals implying that CEO ownership entrenches management.

While our paper is limited in that we only examine the managerial response to shareholder proposals to rescind two specific antitakeover provisions, it certainly addresses the issue of managerial responsiveness to shareholders as discussed in David, Bloom, and Hillman (2007). This topic should be of great interest to shareholders as the American Shareholder Association reported that, in 2007, 70% of voters in the U.S. held stock. If managers are ignoring proposals by a majority of shareholders to remove what are very obviously value destroying antitakeover provisions, shareholders should be concerned about managerial abuse of their fiduciary responsibilities in other areas as well. We have shown that certain board characteristics and ownership structures are able to mitigate this shirking of duties by managers. Donaldson (2003) and Arjoon (2005) conclude that legislating ethical behavior by managers is not successful;

therefore, it is unlikely that Sarbanes-Oxley or similar legislation will bring about desired managerial behavior. Future research in this area must look more closely at governance structures to determine which ones most successfully ensure managers act ethically, and to ascertain whether different structures are more successful when shareholder proposals are related to something other than antitakeover provisions.

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[1] There are many types of antitakeover amendments to corporate charters including blank check preferred stock authorization, cumulative voting, dual class stock recapitalization, and fair price amendments. We do not include these defenses to limit the number of issues examined in the study. These other amendments do not share the clear unethical dimension of the two defenses in the study. There were votes to rescind these measures in the sample period, but most were defeated and those that passed were implemented with rare exceptions.

[2] Gillian and Starks (2000) examine voting outcomes for similar shareholder proposals over the 1987-1994 period and find proposals to repeal classified boards receive 26% support and proposals to remove poison pills receive just over 40% support. Their study contains 299 votes to repeal classified boards and 211 votes to remove poison pills.

[3] Although we focus on governance structure in this paper, it is important to recognize that the processes associated with firm governance are also important for strong corporate governance in a firm.

[4] In the paper, when we discuss outside directors we are referring to independent outside directors as defined and discussed in Harvard Law Review (2006). Specifically, we are viewing independence in the sense of outside unaffiliated individuals whose objective is to promote responsible decision making through reduction of agency conflicts that exist between shareholders and the firm's managers. Any mention in this paper to our variable of outside directors refers solely to independent outside directors as defined in the above law article.

[5] We used 80% domination to be conservative. The result was similar when a lower % of outsiders was used in testing.

[6] We thank one of our anonymous reviewers for bringing this idea to our attention.

[7] This is a rough estimate of large shareholders. Many institutional shareholders keep ownership levels below 5% to avoid reporting. We cannot include these institutions due to their anonymous nature.

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Table 1: Summary of Proposals to Remove Antitakeover Provisions. Proposals to rescind takeover defenses are identified from the IRRC 2000 and 2004 published database during the period from January 1990 through December 2003. The table provides information on the voting and subsequent outcomes of the proposals.

Year	**Classified Board**		**Poison Pill**	
	Pass	*Pass/not implemented*	*Pass*	*Pass/not implemented*
1990	0	0	2	2
1991	0	0	1	2
1992	1	2	2	2
1993	0	0	1	0
1994	1	2	1	1
1995	1	6	1	0
1996	2	5	1	0
1997	5	6	3	3
1998	2	13	2	4
1999	6	14	1	8
2000	31	1	9	0
2001	20	0	12	0
2002	19	2	26	0
2003	23	1	34	0
Total	111	52	96	22

Table 2: Descriptive Statistics and Pearson Correlations for the Full Sample[1]

Data include the proportion of share ownership for inside and outside directors, blockholders, and the CEO. Other data include the proportion of outsiders on the board (Outsiders/Board Size), the size of the board, and the number of blockholders owning firm shares. CEO/Chair dummy represents whether the CEO is also the Board Chair and equals 1 if the CEO and Chair are the same individual. Finally, the table presents the tenure of outsiders, tenure of insiders, and the number of other directorships of outside board members.

Variable	*Mean*	*s.d.*	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*
1. Board size	10.81	3.23								
2. Outsider domination dummy	0.07	0.26	-0.23							
3. Inside control dummy	0.36	0.48	0.11	-0.20						
4. Outsider tenure	8.32	4.26	0.02	0.09	-0.11					
5. Outsider Directorships	1.52	1.46	0.19	0.02	0.06	-0.02				
6. Blockholder ownership%	0.17	0.17	-0.08	0.01	-0.05	-0.04	-0.15			
7. CEO ownership %	0.02	0.06	-0.19	0.08	-0.13	0.09	-0.05	0.13		
8. Insider ownership %	0.04	0.13	-0.06	0.08	-0.13	0.01	-0.06	-0.06	0.17	
9. Outsider ownership %	0.01	0.06	0.08	-0.03	0.09	-0.01	-0.05	0.08	-0.05	0.03

[1] n=289

Table 3. Logistic Regression Results. The model measures the probability that the firm will remove takeover defense once shareholders have voted to rescind the defense as a function of governance and ownership variables. The dependent variable equals one if the takeover defense is removed in firms that passed the proposal and zero if the defense in not removed.

Variable	***Model 3***	
	Parameter	Chi-Square
Board size	0.415	9.09***
Board size*Outside domination dummy	-0.473	7.20***
Outsider domination dummy	4.320	5.26**
Inside control dummy	0.106	0.01
Average tenure of outside directors	0.078	1.08
Directorships per outside director	-1.116	26.73***
Blockholder ownership%	1.050	0.84
CEO ownership %	-17.339	4.04**
Insider ownership %	0.265	0.02
Independent outsider ownership %	-0.878	0.04
Classified board dummy	-0.861	2.98*
Sarbanes-Oxley dummy	1.546	5.00**
Governance Index	0.052	0.28
Firm size	0.101	0.33
Model Chi-Square		106.01***

*   p-value < 0.10
** p-value < 0.05
***p-value < 0.01