

Repealing Classified Boards: What Is the Motivation?

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Abstract

Given the recent growing concerns of corporate shareholders about governance of public firms, there is a significant increase in the number of firms that have eliminated classified boards. The majority of S&P 500 firms have repealed their classified board over the past decade. Early literature [McWilliams, 1990, Lee (Bojanic) and Officer, 1994] suggest insignificant wealth effects on announcement of relatively less restrictive takeover barriers, such as a classified board. With the sensitive environment of lower confidence over the last ten years, investors appear more concerned with management entrenchment problems which could lead to poorly performing firms. This is one motivation for the significant increase in eliminations of classified board provisions. Another related motivation for eliminating the classified board is the requirement of higher levels of independence on corporate boards. This study updates the evidence on the motivation of firms eliminating the classified board in two different years of study: 2004 and 2009 in an attempt to determine reasons behind eliminating an antitakeover provision once viewed as benign.

I. Introduction and Background

Many takeover barriers that were constructed since the merger mania of the 1980's are being eliminated by shareholders in recent years. With the pressure from shareholders for stricter corporate governance any mechanism that may protect management is not desirable. Takeover barriers may entrench management from outside action, whether that was the original intent of the barrier or not. A classified, or staggered board divides the board into (usually three) groups so that only a fraction of all directors are elected every year. One argument supporting the presence of a classified board has focused upon the stability and consistency that this provision provides for a monitoring body.

In the March 23, 2012 Harvard Law School Forum on Corporate Governance and Financial Regulation, it is reported that the Harvard Shareholder Rights Project (SRP) urged several institutional investors to send proposals to declassify boards to 80 companies in the S & P 500 that still have a staggered or classified board. The report states that 42 of the 80 companies agreed to include management proposals in their proxy statements to declassify their board. Furthermore, the SRP praised these 42 companies for "their responsiveness to shareholder concerns." (Lipton and Mirvis, 2012). Lipton and Mirvis state that there is no evidence that declassifying boards enhances firm performance but instead may leave a corporation more vulnerable to unwanted takeover bids. A researcher at *The Conference Board* reports that shareholder concerns over classified boards are still growing and that "shareholders are determined to question the rationale for not having all corporate directors face a confidence vote on an annual basis" [Aguilar, 2012].

Across all indices (i.e., S & P 500, Mid-Cap, and Small-Cap) the number of companies with classified boards has declined over the last several years. By the end of 2008, just 50% of the S & P 1,500 companies maintain a classified board. This is the first time that a majority of

public companies do not have a classified board. The most significant drop has been in the largest companies, the S & P 500 companies. Only 36% of S & P 500 companies maintain a classified board at the end of 2008 compared to 56% in 2004. Larger companies tend to be more high-profile and therefore attract more investor scrutiny than the smaller-cap firms. With higher investor scrutiny, there is pressure from shareholders to eliminate any mechanism that decreases the likelihood of ousting poorly performing management. For Mid-Cap firms, 57% had classified board provisions in 2008 compared to 67% in 2004. Likewise, classified board provisions have dropped to 56 % for small-cap firms in 2008, compared to 62% in 2004. The drop in the classified board provision is also consistent with the (required) increase in board member independence. In 2008, shareholder proposals to declassify boards received the highest average support for any type of shareholder proposal (RiskMetrics, 2009). This study attempts to offer more evidence on the possible motivation of eliminating the classified board provision.

Over the last two decades numerous studies have examined the possible benefits and costs of takeover barriers. McWilliams (1990), using a sample of 325 firms proposing 763 antitakeover amendments finds insignificant shareholder wealth effects on announcement of the barrier. The sample included classified board provisions along with fair price and supermajority amendments. Lee (Bojanic) and Officer (1994), using a sample of 765 firms constructing 890 barriers find insignificant wealth effects of the amendments (including classified boards) but significant negative reactions on announcement of poison pill plans. Two competing hypotheses of takeover barriers have been posed: the managerial entrenchment hypothesis and the shareholder interest hypothesis. Consistent with agency theory, the management entrenchment hypothesis (Jensen and Meckling, 1976) states that managers construct takeover barriers to protect their job positions with the firm. According to the shareholder interests hypothesis, target company shareholders accept takeover barriers as a way for managers to extract a higher bid price. It appears that the early literature on the possible effects of specifically classified boards does not lend support for either hypothesis. However in this changing environment and the growing concern of shareholders for transparency prompting stricter corporate governance, it appears that shareholders believe that eliminating classified boards will benefit the shareholders. This is evidenced by the growing number of firms that now have boards with annual elections.

The requirement for increased board independence, since the 2002 Sarbanes-Oxley (SOX) Act, could be another motivating factor in the elimination of classified boards. To meet new independent board level requirements, we have seen an increase in the number of independent board members. The average board independence levels have been steadily rising, to 78% in 2008, up from 74% in 2007 and 72% in 2003. In 2008, 98% of the S & P 1,500 companies have a board of directors that has a majority of independent members, up from 83% just five years earlier (RiskMetrics, 2009). A recent study of S & P 500 firms (Lee and Carlson, 2007) shows that firms with the most independent boards perform significantly better than firms with less independent boards. With the elimination of a classified or staggered board, more board seat members can be removed from the board, allowing for more independent members.

Will the evidence show that firms are motivated to eliminate their classified board in order to oust management from underperforming companies or do these firms have relatively low independence levels on the board and need to make way for independent members? The largest drop in corporations with classified boards has been over the five year period 2004 to

2009. In an attempt to isolate possible changes in the motivation for eliminated boards, the sample of firms eliminating the classified board is divided into a 2004 sample and 2009 sample. Furthermore, the two samples are identified as S & P 500, mid-cap, or small-cap firms in order to further isolate reasons for the declassification.

II. Hypotheses

This study examines firms that eliminated their classified board provision in two different time periods, 2004 and 2009 in an attempt to capture possibly different motivations in different time periods. In the corporate environment of 2003/2004, the recent corporate failures and fraud were still fresh in the minds of investors and poorly performing firms would be under additional pressure to increase transparency and accountability to shareholders. Therefore we may find that the firms declassifying in 2004 had significant poor firm performance compared to other firms in their respective industries. Shareholders of poorly-performing firms may wish to have the ability to get rid of management with more ease when the board is not staggered. Years later in 2009, we may observe that this is not the motivating factor among firms declassifying their boards. Many firms have simply followed the trend answering to the general voice of the investor market for increased accountability. Two sets of hypotheses follows:

Null Hypothesis: Mean of Board Independence Level of 2004 sample of declassifying firms is not significantly different from the mean of board independence level of declassifying firms in the 2009 sample.

Alternative Hypothesis: Mean of Board Independence Level of 2004 sample of declassifying firms is significantly different from the mean of board independence level of declassifying firms in the 2009 sample.

Null Hypothesis: Mean of Industry-Adjusted ROA's for the 2004 sample of firms declassifying their board is not significantly different from the mean of Industry-Adjusted ROA's for the 2009 sample.

Alternative Hypothesis: Mean of Industry-Adjusted ROA's for the 2004 sample of firms declassifying their board is significantly less than the mean of the industry-adjusted ROA's for the 2009 sample

Another motivating factor may be the requirements for increased board independence. In order to refresh some of the board seats with independent members, some firms have eliminated the classified board that prevented election of a majority of seats at any one time. Lee (2008) finds that increased board independence is not a significant factor affecting firm performance for small-cap firms whereas Lee and Carlson (2007) find a significant positive relationship between increased independence levels and firm performance in large-cap firms (i.e., S & P 500). So for the larger firms, there may be two reasons for increasing independence levels; one is to meet new requirements and the other is to boost firm performance through the reduction of agency costs. For smaller firms, there appears to be less concern about agency costs (Lee, 2008). This may be the reason the trend to declassify boards has been less pronounced with mid-cap and small-cap firms.

As noted earlier, with stricter requirements from the 2002 SOX Act, many public companies needed to form more independent boards. By declassifying boards, higher board independence levels can be more easily achieved. This may have been more of a factor in the earlier sample year of 2004 rather than 2009. For the second set of hypotheses, any differences in the mean of the industry-adjusted ROA's are examined, comparing these means of declassified firms of 2004 vs. 2009. The most significant increase in eliminations of classified board provisions has been in the large-cap firms that are under the most investor scrutiny. To further test the two sets of hypotheses, the sample of firms in each year of study will be subdivided into large-cap, mid-cap, and small-cap firms. This may help isolate possible motivations for the declassification.

After years of declassifying actions, the majority of firms in the S & P 1,500 do not have a classified board provision and there continues to be proposals for more firms to eliminate the provision. What was the motivation for the elimination? Was the firm performing poorly in the period prior to the elimination of the classified board? If so, perhaps the motivation was to prevent further entrenchment of bad management. On the other hand, was the independence of the board significantly below the average for S & P 500 firms? If yes, then elimination of the classified board would expedite the process of increasing board independence.

III. Data and Methodology

For the S & P 500 companies, those firms which have eliminated the classified board provision in 2004 and 2009 are identified from Investor Responsibility Research Center (IRRC) publications (2005 and 2010), and the Georgeson Annual Reviews (2004 and 2009). As shown in Table I, descriptive statistics of these companies include the following variables in the year before the classified board was eliminated: 1) Independence levels of the board, 2) Board size, 3) Return on assets, 4) Average return on assets of the respective industry, and 5) Total Assets (as a proxy for firm size). The firm performance is calculated using an industry-adjusted return on assets (ROA) as used in many corporate governance studies examining the effect of specific variables on firm performance (Eisenberg, Sundgren, and Wells, 1999; Yermack, 1996; Lee and Carlson, 2007; Lee, 2008). In other words, [Firm ROA – Industry Average ROA] is used as a relative firm performance measure, and will be referred to as an industry-adjusted ROA in this study. ROA, industry-adjusted ROA, and total assets (\$) are collected from *Compustat*.

The data is analyzed to determine any relationships between firms declassifying their board of directors and their respective board independence and firm performance levels. To test for significant differences in variable means of both board independence and firm performance between those firms declassifying boards vs. the means for that firm size category (i.e., S & P 500, Mid-cap, Small-cap) or industry respectively, t-tests between means are performed. Initially, t-tests are performed to determine if several variable means, including board independence levels and industry-adjusted ROA of the firms declassifying in 2004 are different from those of declassifying firms in 2009 (Table I). For board independence levels and industry-adjusted ROA's, t-tests are performed (Tables II and III) to test for significant differences, either from the mean or from zero, respectively. To further examine possible differences between variable means comparing 2004 to the 2009 sample, t-tests are performed to test for any

significant differences, dividing the 2004 and 2009 sample into S & P 500, mid-cap, and small-cap to attempt to isolate any motivations for the declassification (Table IV).

IV. Results

In 2004, thirty-five (35) firms declassified their board and forty-one (41) firms in 2009. As shown in Table I, two (2) variables, Industry-Adjusted ROA and Total Assets were significantly different between samples of firms declassifying the board of directors in 2004 vs. those firms declassifying in 2009. At the 5% level of significance, the total assets of firms declassifying their board in 2004 were significantly larger than those that declassified in 2009. In addition, declassifying firms in 2004 had mean industry-adjusted ROA's significantly less than those firms declassifying in 2009 at the 10% level. In 2004, it appears that larger firms (i.e., higher total assets) that were not performing as well (i.e., significantly negative industry-adjusted ROA) as the average firm in their respective industry were declassifying their boards. This suggests that in the early years after the enactment of SOX, larger poorly-performing firms were quicker to declassify, and that in 2009, firm performance may not be the driving factor to declassify. However, there is stronger evidence of this when the sample is divided into S & P 500, mid-cap, and small cap subsamples, and the direct test of means between 2004 and 2009 is made in Table IV.

TABLE I
Descriptive Statistics of Entire Sample
Includes T-Tests between Means
Divided by Firms Declassifying the Board of Directors
2004 vs. 2009

Variable	Declassifying 2004 N = 35	Declassifying 2009 N = 41
Mean (Standard Deviation)		
Board Independence %	76.27 (12.37)	77.67 (10.52)
Industry-Adjusted Return On Assets (ROA) **	-1.25 (4.75)	1.15 (10.03)
Board Size	11.26 (2.33)	10.98 (2.26)
Total Assets (\$ millions) *	51364.76 (127166.16)	12984.85 (15366.92)

* Significant difference in Means between the two samples at the 5% level of significance.

** Significant difference in Means between the two samples at the 10% level of significance.

Two variables, industry-adjusted ROA and Total Assets are significantly different between samples of declassifying firms in 2004 vs. those declassifying in 2009.

A. Board Independence and Firm Performance

Table II shows the breakdown of both samples by size of the firms, specifically, S & P 500, mid-cap, and small-cap firms. Consistent with Table I, the results in Table II show that thirty-one firms (or 89%) of the firms declassifying in 2004 were in the S & P 500, whereas just 58% of the declassifying firms in 2009 were large-cap firms.

TABLE II
Board Independence as of End of 2003 or End of 2008
Firms Declassifying Boards in 2004 and 2009
Testing for Differences from Mean Board Independence of All Firms in the Same Time
Period, Further Divided by Large-Cap, Mid-Cap, and Small-Cap Firms

	2004	2009
	Declassification S & P 500 n=31 Mid--Cap n=3 Small-Cap n=1	Declassification S & P 500 n=24 Mid-Cap n =9 Small-Cap n=8
Board Independence %:		
S & P 500 Firms	77.03 (72.0) t=2.24 *	80.04 (81.0) t=.60
Mid-Cap Firms	70.78 (68.0) t=.36	69.57 (78.0) t=-1.84 **
Small-Cap Firms	69.0 (66.0) n/a (n=1)	79.7 (75.0) t=1.87 ***

() Means for all Large-cap, Mid-cap, and Small-cap firms respectively.

* For these Large-Cap firms, there was a significant difference (at the 3% level) between means of the firms declassifying boards in 2004 and the average independence level of 72% for all S & P 500 firms at year-end 2003.

** For these Mid-Cap firms, there was a significant difference (10% level) between means of the firms declassifying boards in 2009 and the average independence level of 78% for all Mid-cap firms at year-end 2008.

***For these Small-Cap firms, there was a significant difference (10% level) between means of the firms declassifying boards in 2009 and the average independence level of 75% for all Small-cap firms at year-end 2008. In 2004, there is only one small-cap firm and therefore no conclusion can be made about the influence of board independence on board declassification for 2004 small-cap firms.

As mentioned earlier, the large-cap firms are under greater scrutiny and therefore more pressure to remove any type of management protection devices. The classified board provision alone has not been a restrictive antitakeover barrier but when combined with other provisions such as poison pill plans, can make it very difficult for outsiders to get rid of underperforming management. There has been less activist pressure on mid-cap and small-cap firms to declassify boards. However, over the past several years, an increasing trend to declassify boards has been observed in mid-cap and small-cap firms, but at a much slower pace than that of the larger S & P 500 firms.

In Table II, board independence percentages of each sample are tested for significant difference between means of the sample and all firms in that respective category (i.e., large-, mid-, or small-cap). In the 2004 sample, large-cap (S & P 500) firms have board independence levels significantly different (at the 3% level) from the mean of all S & P 500 firms at year-end 2003. Specifically, large firms in 2004 that declassified their board had an average independence level of 77% vs. 72% for all S & P 500 firms. So, it does not appear that the need for more board independence is a motivating factor for large firms in the 2004 sample. In that same year, there was no significant difference in board independence levels in the mid-cap and small-cap firms.

TABLE III
Firm Performance Measure (Industry-Adjusted ROA)
As of end of 2003 or End of 2008
Testing for Differences from Zero Within the Same Time Period
Firms Declassifying Boards in 2004 and 2009
Further Divided by Large-Cap, Mid-Cap, and Small-Cap Firms

	2004	2009
	Declassification S & P 500 n=31 Mid--Cap n=3 Small-Cap n=1	Declassification S & P 500 n=24 Mid-Cap n =9 Small-Cap n=8
ROA (Industry-Adjusted):		
S & P 500 Firms	-0.58 t=.40	1.16 t=.60
Mid-Cap Firms	-2.63 t=.37	5.14* t=.08
Small-Cap Firms	-10.63 n/a (n=1)	-3.36 t=.33

* For these Mid-Cap firms, there was a significant difference (8% level) between the means of the industry-adjusted ROA of the firms declassifying boards in 2009 and zero for all Mid-cap firms at year-end 2008. Mid-Cap firms declassifying the board of directors in 2009 performed significantly better than the average firm in their respective industries. In 2004, there was only one small-cap firm and so no conclusion can be made about the influence of firm performance on board declassification.

In Table II, in the 2009 sample there appears to be significant board independence level differences in both the mid-cap and the small-cap group in opposite directions. However, given the small sample sizes in both the mid-cap and small-cap firms and the level of significance at 10%, it is difficult to draw a conclusion. It appears that the mid-cap firms declassifying boards had significantly lower board independence than other mid-cap firms. Declassifying mid-cap firms have a mean board independence level of 69.6% vs. and the average independence level of 78% for all mid-cap firms at year-end 2008. This implies that declassification of the board may be “making room” for moving some independent directors onto the board, and may then be a motivating factor.

Table III provides data on the comparison of firm performance of declassifying firms vs. other firms in the same industry, once again divided by size of the firms. Though negative, it does not appear that large declassifying firms (i.e., S & P 500 firms) do not perform significantly different from firms not declassifying in that time period. However, it appears that mid-cap firms performed significantly better than the average firm in their respective industries. The industry-adjusted ROA for mid-cap firms in the 2009 sample was + 5.1433%, significant at the 8% level. Most likely, these mid-cap firms did not receive pressure to declassify the board due to poor performance but perhaps are motivated by the lower than average independence levels on the board. By declassifying the board, more seats can be filled in any one year by new, independent directors. In the other direction, the small-cap firms that are declassifying boards in 2009 have significantly greater independence levels than all small-cap firms, 79.7% compared to 75%. As noted earlier, there are small sample sizes for both the mid-cap and small-cap firms, and therefore any conclusions from testing of these two subsamples is tenuous.

B. Comparison of 2004 vs. 2009 By Firm Size

To directly compare the differences in the variables between the 2004 and 2009 sample, divided by size of the firms, additional t-tests were conducted. In Table IV these results are provided.

TABLE IV
Mean Variable Comparison between 2004 and 2009 Samples
Divided by S & P 500, Mid-Cap, and Small-Cap

Variable	2004	2009	t - value
Mean			Significance Level
(Standard Deviation)			
<u>S & P 500</u>	N =31	N=24	
Board Independence %	77.0 (12.51)	80.0 (8.84)	-1.04 0.27
Industry-Adjusted Return On Assets (ROA)	-577 (3.78)	1.16 (10.76)	-0.84 .032*
Board Size	11.06 (1.83)	11.08 (1.84)	-1.04 0.27
Total Assets (\$ millions)	57562.05 (134085.6)	18113.17 (18220.2)	1.62 0.01*
<u>Mid-Cap Firms</u>	N=3	N=9	
Board Independence %	70.78 (13.21)	69.57 (13.78)	0.14 0.48
Industry-Adjusted Return On Assets (ROA)	-2.63 (3.95)	5.14 (7.69)	-0.16 0.35
Board Size	12.67 (6.11)	10.04 (2.29)	1.17 0.05*
Total Assets (\$ millions)	4354.9 (3407.13)	6332.94 (5242.71)	-0.60 0.52

No Small-Cap comparison due to sample size N=1 for 2004.

* Significant difference in means between the two samples at the 5% level of significance.

In comparing the means of the variables by firm size, it appears that within the S & P 500 firms declassifying their boards, the significantly larger firms declassified in the early years after the SOX act. In 2009, the significantly smaller S & P 500 firms declassified. This is consistent with the fact that the majority of S & P 500 firms no longer have a classified board. It is very interesting that the S & P 500 firms that declassified in 2004 performed significantly worse than S & P 500 firms that declassified in 2009. It is very plausible that these large, poorly performing firms were pressured to declassify their boards. It also appears that the need to make room for a higher board independence level was not a motivation for declassifying. The difference in means of board independence is not significant between the two periods for S & P 500 firms.

The results for the mid-cap firms in Table IV show that only board size is significantly different for those firms declassifying in 2004 vs. 2009 for that firm size. Specifically it may be that the mid-cap firms with larger boards were among the first to declassify their board. As mentioned earlier, due to the small sample size of mid-cap firms, these results are not strong. However, by separating the entire sample into S & P 500, mid-cap, and small-cap firms, we see very clearly that the “largest of the large” firms in the S & P 500 were performing significantly worse than the average firm in their respective industries.

V. Conclusion

It appears that the initial motivation to declassify boards for the large-cap firms was the pressure from shareholders to eliminate protective barriers for underperforming management. The pressure on large firms to become more accountable was great in the early years near the 2002 Sarbanes-Oxley Act. Eighty-nine percent of the declassifying firms in 2004 were in the S & P 500. Also, when comparing the 2004 firms to the 2009 firms, the industry-adjusted ROA's were significantly lower in the 2004 sample. In examining the S & P 500 firms alone, it also appears that the largest of the S & P declassified in 2004 vs. 2009, and that the motivation for declassifying in 2004 may have been to decrease agency costs. Eliminating the classified board is another way to make management more accountable for their actions; perhaps more important with firms performing poorly. Several years later, it appears the motivation to declassify may be an attempt to increase board independence levels, as seen in the mid-cap firms (2009 sample). Board independence levels were significantly lower than other firms in their respective industries for mid-size firms. As noted earlier in this paper, today activist groups are urging all public corporations to declassify their boards, not just the underperforming firms as in 2004.

This study expands the literature on the motivation of eliminating a classified board provision and sheds light on its diminishing popularity. The classified board, once a very common takeover barrier that appeared somewhat benign in its shareholder wealth effects, is no longer desired by shareholders, especially in the large firms. Now mid- and small-cap firms are following the example of the larger firms in eliminating the staggered board. By further separating the two sample years by size of the firms, we found different motivations for different size firms. This study provides more evidence on the possible motivation of shareholders in board declassification. This trend is continuing and it will be interesting to examine if the elimination of the classified board is indeed good for increasing shareholder wealth.

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