

February 22 mk

Takeover defenses in spinoffs: agents protecting agents

Robert Daines and Michael Klausner

Takeover defenses in spinoffs: agents protecting agents

Because a spin-off generally does not require a shareholder vote, it affords an opportunity to arm the firm with a full complement of anti-takeover provisions.

- Fried Frank Harris Shriver & Jacobson, Materials promoting the benefits of spinoff transactions

Prior studies have found that spinning off a subsidiary tends to be value-increasing transaction for a firm. No one, however, has examined the governance structure of the firms that are spun off in these transactions, or the possibility that, notwithstanding overall gains from spinoff transactions, these firms' governance structures may be systematically suboptimal. When a company spins off a subsidiary, managers of the parent firm determine the governance structure of the spinoff and are not required to seek the approval of shareholders, either for the overall transaction or the governance structure of the firm.¹ Most importantly, parent managers determine whether the spinoff's charter will provide for a staggered board or other protection against hostile takeovers. Moreover, some of those same parent managers will become managers of the spinoff and therefore become the beneficiaries of takeover protection that the spinoff may have in place. The cost of entrenchment would be born by parent shareholders to the extent one would expect share prices to reflect entrenchment. If the spinoff's shares are distributed to parent shareholders, parent shareholders will directly bear the cost of the spinoff's management's

¹ No shareholder vote is required for a spinoff in Delaware, where roughly 60% of public firms are incorporated (Daines, 2000b). Several states (like New York, with a 5% share of public firms) may require a vote when the spinoff constitutes all the firm's assets. Even in these states, however, a significant fraction of a firm's assets may be spun off without shareholders consenting to the firm's governance.

entrenchment. If, instead, the spinoff is structured as a sale of stock by the parent to the public, parent shareholders will bear the cost indirectly as a result of the parent receiving lower proceeds from the sale.²

Whether parent managers do in fact adopt suboptimal governance structures for spinoffs is an empirical question the answer to which should depend on the extent to which parent management's interests are aligned with their shareholder interests—through high shareholdings, for instance—and on the extent to which parent managers have an interest in entrenching the spinoff's managers. If the parent's decision makers are the same people who become managers of the spinoff, one would be especially concerned that the balance of incentives would yield an entrenching governance structure.

In this paper, we investigate the following questions: First, are spinoff managers more protected from hostile takeovers than managers of a size- and industry-matched sample of firms going public? Second, to the extent takeover protection is prevalent in spinoffs is it motivated by an interest in entrenching management or by an interest in maximizing share value?. Third, when parents spin off a subsidiary, do they tend to provide the spinoff with more takeover protection than the parent has? Finally, what is the impact of spinoff takeover protection on parent share values?

This paper adds to the literature on the sources of efficiency gains attributable to spinoffs, cautioning that those net gains may mask increases in agency costs. **[add description of spinoff literature]**

In addition, the paper adds to the large literature analyzing self-serving management

² We treat these two types of transaction as equivalent and refer to both as “spinoffs.” In one type of transaction, the shares of a subsidiary are distributed to parent shareholders as a dividend. In the other type of transaction, the parent sells the shares of the subsidiary to the public. We refer to the firm doing the spinoff as the “parent” and to the spun off subsidiary as the “spinoff.”

decisions. We already know, for example, that managers may entrench themselves at shareholder expense (Bradley, Desai and Kim, 1983), use too little debt (Stulz, 1990), consume too many perks (Jensen, 1986), resist valuable takeover opportunities (Pound, 1987), over-diversify (Lang and Stulz, 1994; Berger and Ofek, 1995), and manipulate the timing of CEO option awards (Yermack, 1997). **[update?]** In this paper, we examine whether managements' decisions regarding the governance structure of spinoffs similarly reflect managers' self-interest, rather than shareholders' interest. The potential result of agency costs in this case is not just a static welfare loss, however, but also increased entrenchment that could lead to *increased* agency costs—thereby reducing the potential gains that a spinoff creates.

We find that spinoffs' charters include substantially more protection against hostile takeovers than do the charters of a size- and industry- matched sample of IPO firms, and that this protection seems to be motivated by an interest in entrenching management. Comparing spinoffs to their parent firms, we find that spinoffs tend to have more takeover protection than their parents do. Parent managers apparently use the occasion of the spinoff to increase takeover protection for the business being spun off. Finally, we find that entrenchment of spinoff management is costly to parent shareholders.

The fact that parent managers commonly adopt charter terms for spinoffs that are more entrenching than their own charters raises a normative question. This change in charter terms accomplished via a spinoff is functionally equivalent to a charter amendment, which requires a shareholder vote. Shareholders, however, are not generally entitled to vote on the charter of the spinoff. Thus, perhaps parent firms should be prohibited from including in the charter of a spinoff a takeover defense or any other provision that significantly alters shareholder rights if

that provision is not already present in the parent's charter.³

I. ITT's Defense Against Hilton's Takeover Attempt—An Extreme Example?

In 1997, Hilton Hotels Corp. attempted a hostile acquisition of ITT Corp. To fight off the bid, the managers of ITT transferred nearly all the firm's assets to a subsidiary, endowed the subsidiary with a staggered board and poison pill, and attempted to spin off the subsidiary to ITT shareholders. With the staggered board and poison pill, the managers of the spun off company would be able to resist a takeover for approximately two years—the time needed for Hilton to mount proxy contests in two annual meetings to oust two-thirds of ITT's directors and to install new directors who would deactivate the pill. This delay would be costly to Hilton, as ITT managers would remain in control of the target and could use the delay to thwart Hilton's plans, by seeking an alternative acquirer or otherwise.

Hilton challenged ITT's action in court and obtained a permanent injunction enjoining ITT from implementing this defense. The court concluded that ITT management could not thwart Hilton's takeover attempt by depriving ITT shareholders of their right to elect a board annually, a right that they had under ITT's charter. While ITT could adopt a staggered board in the proper manner, through a shareholder vote, it could not do so through the back door of a spinoff—at least not with a hostile bidder at the door. The poison pill was not problematic since any company can adopt a poison pill without shareholder approval.

ITT's actions are an extreme and dramatic case—extreme because nearly all of ITT's business (and all its top management) would be transferred to the spinoff, and dramatic because

³ This proposed rule would be similar to the rule allowing a firm to merge with another firm without a shareholder vote if the merger partner is sufficiently small and *if the merged entity will have a charter that is substantially the same as the pre-merger charter*. DGCL ____.

the transaction was proposed as a direct response to a takeover attempt. But perhaps the ITT takeover defense is simply a highly visible version of business as usual when spinoffs occur. The remainder of this paper investigates that question.

II. Potentially Entrenching Governance Structures

The most common and important takeover defenses that appear in charters are staggered boards and restrictions on shareholder voting between annual shareholders meetings.⁴ When combined with a poison pill, which a board can adopt essentially instantaneously without shareholder action, each of these charter provisions can delay a hostile takeover. Unless a court orders a board to redeem a poison pill, or the target board voluntarily relents, the only way for a takeover to proceed once a pill is adopted is to replace the target board with a new board that will redeem the pill. Thus a hostile acquirer will typically combine a tender offer for target shares with a proxy contest to have target shareholders replace the target board. If the target has a staggered board, however, only one-third of the board can be replaced at an annual meeting. Consequently, it takes two annual meetings to fill a majority of board seats. In a company with a nonstaggered board, target shareholders can always replace the board at the next annual meeting, but that could be a year or more away.⁵ Depending on the target's charter, target shareholders may be able to replace the board sooner—typically within 60 to 90 days—by either calling a special shareholders meeting or by voting by written consent. A company's charter can either allow or disallow such interim voting. A charter that disallows interim voting—by both

⁴ Dual class stock is more entrenching but not common.

⁵ Some states require annual meetings to take place within 12 months of the prior year's meeting. Others allow up to 18 months between annual meetings. See Coates (2000), who creates an index of the degree to which ATPs in various combinations impede takeovers. Appendix A

preventing shareholders from voting by written consent and prohibiting them from calling a special meeting—operates as a takeover defense, albeit a less effective defense than a staggered board, by requiring an acquiror to wait until the target's next annual meeting to try to replace the board.

Empirical studies of antitakeover charter provisions have produced somewhat mixed results, but the weight of the evidence indicates that staggered boards are detrimental to shareholders. Jarrell and Poulsen (1987), Baghat and Jefferis (1991), and Daines (2001) find that their adoption has a negative impact on share prices.⁶ Two hypotheses have been proposed regarding the possibility that takeover defenses in general can enhance share value. First, takeover defenses may increase share value by increasing a target firm's bargaining power once a hostile bid has been made, allowing the target to extract a higher price from the bidder. DeAngelo and Rice (1983), Stulz (1988). Bebchuk, Coates and Subramanian (2003), however, find that in the case of staggered boards, bidders are deterred from making bids and takeover premia are unaffected. Second, entrenching provisions may respond to the problem of rational myopia, allowing a firm to invest in long-term projects whose value may not be reflected in the firm's share price. Stein (1988, 1989) models this in terms of asymmetric information and costly

describes these ATPs in detail along other ATPs that appear in our sample.

⁶ **Sort out what to do with the following:** State legislation event studies. See Collins, Black and Wanesley (1993), Szewczyk and Tsetsekos (1992), Ryngaert and Netter (1988), Margotta, McWilliams and McWilliams (1990), Schumann (1988), Pugh and Jahera (1990), Karpoff and Malatesta (1989) and studies reviewed in Romano (1992). DeAngelo and Rice (1983) and Linn and McConnell (1983) find statistically insignificant negative abnormal returns surrounding ATP amendments, but they use sample periods that predate the courts' approval of the poison pill. Consistent with the results of event studies, Pound (1987) finds that ATPs deter takeover bids without yielding higher premiums, and that management is more likely to resist a bid if its firm has an ATP. Borokhovich, Brunarski and Parrino (1997) find that some ATPs can deter bids. Mikkelson and Partch (1997) find that an active market for corporate control leads boards to replace poorly performing CEOs, which is consistent with the view that ATPs entrench poorly performing CEOs by reducing the threat of a takeover bid.

signaling, Shleifer and Vishny (1990) model it in terms of costly arbitrage, and DeAngelo and Rice (1983), Knoeber (1986), and Borokhovich, Brunarski & Parrino (1997) reach the same result by focusing on the incentives that executive compensation can create. Empirical tests of this hypothesis have been mixed (Meulbroek, Mitchell, Mulherin, Netter & Poulsen (1990), Johnson and Rao (1997), Pugh, Page & Jahera (1992)).

III. Sample and Methodology

A parent can spinoff a subsidiary in one of two ways. It can distribute shares of the subsidiary to its shareholders, or it can sell the subsidiary's shares in a public offering. Under either transactional form, the parent can distribute all of the subsidiary's shares or a fraction of its shares. Our sample period is July 1, 1993 to December 31, 1997.⁷ During this period, Securities Data Corporation (SDC) Mergers and Acquisitions database lists ____ spinoffs in which a majority of shares were distributed to shareholders. In drawing our sample, we began with these firms and excluded bank holding companies, REITs, firms that SDC had miscoded, and firms for which we could not obtain data on charter terms. This reduced our sample of this type of spinoff to [91]. During the same period, the SDC New Issues database lists ____ spinoffs in which a majority of shares were sold to the public. Of these, we excluded ____ for the reasons described above. This gave us a total of [106] firms in which the parent had sold a majority of shares. We refer to all these firms as "spinoffs" and do not differentiate between those whose shares were distributed to parent shareholders and those whose shares the parent sold to the public.

When a parent spins off a subsidiary, it commonly begins by selling—or "carving out"—a minority interest to the public as a first step, and later distributing their remaining interest to

parent shareholders. Parent firms often announce their intention to complete such a two-step spinoff in the first stage. When this is the plan, or even if it is just a possibility, one would expect the parent to settle on charter terms at the time of the initial carve out. If it waits to amend the charter later, at the time it divests itself of control, a shareholder vote would be required, which would entail an unnecessary expense and the possibility of shareholder rejection. Consequently, even the charters of firms in which the parent retains majority ownership are likely relevant to our inquiry. We therefore supplement our sample with 54 firms of this type that were randomly selected from the same sample period. Our final sample thus includes 160 full or partial spinoffs announced between June 1, 1993 and December 31, 1997. Table 1 provides descriptive statistics for the sample.

Table 1: Descriptive Statistics

[to be added]

As a benchmark against which to compare takeover protection in spinoffs, we collected a size- and industry-matched sample of firms that went public during our sample period. The details of our matching algorithm are explained in Appendix A. This procedure produced reasonably close matches in terms of industry: 91% of matched-firms are in the same 4 or 3 digit SIC code but less close matches in terms of size because spinoffs tend to be larger than IPOs.

For each company in our sample of spinoffs and matched non-spinoff IPOs, we obtained documents filed with the SEC at the time of the spinoff or IPO, as well as a charter filed as an

⁷ This dataset was originally collected in connection with Daines and Klausner (2000).

exhibit to the prospectus. From these documents, we collected data on takeover defenses included in each firm's charter. We also collected data on the each company's board of directors and top management from the first proxy statement that the company filed following the spinoff or IPO. In addition, we collected data on parent firms from the proxy statement for the annual meeting preceding the spinoff.

IV. Empirical results

The initial question that we address is whether parent managers provide spinoffs with protection against takeovers in order to entrench spinoff managers. We investigate that question in three ways. First, we examine whether spinoff charters are more protective than the charters of start up firms doing initial public offerings, where pre-IPO shareholders determine the contents of the post-IPO charter and have an interest in maximizing firm value. Second, using a matched-pair logit regression, we analyze whether the difference between spinoffs' defenses and IPO defenses is explained by factors related to shareholder welfare. Third, using a cumulative logit regression, we analyze directly whether takeover protection in spinoffs is related to factors indicating an interest in management entrenchment or to factors indicating a motivation to increase share value.

The possibility that parent managers can protect spinoff management against takeovers raises the related question whether they draft spinoff charters to include more protection than the parent charters provide at the time of the transaction. In other words, as in the ITT case, by bundling a takeover-protective charter with a spinoff, parent managers can effect a charter amendment without a shareholder vote. We investigate the extent to which this occurs, and to the extent it does occur whether such bundling is value-reducing?

A. Prevalence of takeover protection in spinoffs relative to IPOs

The first step in the analysis is to determine whether takeover defenses are prevalent in spinoffs. As shown in Table 2, it is clear that they are. Approximately 65% of spinoffs have staggered boards, and 52% of spinoffs prevent shareholders from initiating a vote outside of annual meetings.⁸ Since our concern is that parent managers establish these defenses in order to protect spinoff managers, rather than to promote the interests of their shareholders, we compare takeover defenses in spinoffs with takeover protection in the matched sample of IPOs. Although the charters of ordinary IPOs may have more takeover protection than we might expect (Coates (2002), Daines and Klausner (2001) and Field and Karpoff (2002)), we would expect the pre-IPO manager-shareholders, who decide whether to include takeover defenses in their charter, to be more concerned with the impact of those defenses on share values than are the parent managers who write the charters of spinoffs. As Table 2 shows, this expectation is borne out in the data. The difference between spinoffs and IPOs in the use of staggered boards and shareholder voting restrictions is large and statistically significant.⁹

Table 1
Takeover defenses in spinoff and IPO charters

This table compares the inclusion of takeover defenses in the charters of spinoffs and a size- and industry-matched IPOs. Voting restrictions refer to charter provisions that both prohibit shareholders from calling a special meeting and prohibit voting by written consent. Even among companies that allow shareholders to call a special meeting, there are commonly requirements that a percentage of outstanding shares as high as 50% are needed to do so. Such requirements, however, are not counted as restrictions here.

Type of Provision	Present in spinoff	Present in IPO
Staggered Board	64.6% ^{**}	46.2% ^{**}
Voting Restrictions	52.2% ^{***}	24.1% ^{***}

⁸ [Among just firms with annually elected boards?]

⁹ In unreported tests, we obtain similar results when we omit minority carve outs.

** Significant at .01 level using McNamar test for matched pairs
***Significant at .001 level using McNamar test for matched pairs

The prevalence of takeover defenses in spinoffs relative to IPOs does not necessarily mean that defenses in spinoff charters are motivated by a desire to entrench spinoff management. Alternative efficiency hypotheses are available. It is possible that defenses tend to enhance shareholder value in spinoffs more than they do in IPOs, and that this explains their prevalence in spinoffs. To test this hypothesis, we ran a matched-pair logit regression, comparing defenses in spinoff charters with those in IPOs, in which we include control variables that proxy for factors that would suggest efficiency reasons takeover defenses. With these controls, a significant difference between spinoffs and IPOs would provide greater support for the hypothesis that the presence of takeover defenses in the charters of spinoffs is attributable to an entrenchment objective.

There are two scenarios in which a takeover defense may enhance shareholder value. First, when it is needed to provide a firm with bargaining power in the event that a hostile bid is made (the Bargaining Power Hypothesis); and second, when managers would otherwise be rationally myopic and underinvest in long-term projects that the market will have difficulty valuing (the Rational Myopia Hypothesis).

1. *The Bargaining Power Hypothesis*

The Bargaining Power Hypothesis posits that a takeover defense can increase share value by enhancing the bargaining power of a firm's management when a bid is made, thereby enabling management to extract a higher price from a bidder. The prospect of a higher premium may outweigh the fact that defenses may also deter bids in the first place (Stulz 1988). The

bargaining power that a defense provides is most useful when a target firm has only one potential acquiror. If more than one party is potentially interested in acquiring a target firm, then actual or potential competition among bidders will force bid prices higher and protect target shareholders even without a takeover defense (Bebchuk, 1982; Gilson, 1982; Zingales, 1995). On average, the more parties there are attempting to acquire companies in a particular industry, the more actual or potential competition there will tend to be for target firms in that industry, and the less a firm will need a takeover defense to enhance its bargaining power. Consequently, the Bargaining Power Hypothesis implies that there will be a negative relationship between the competitiveness of the market for corporate control in an industry and the presence of takeover defenses among firms in that industry.

To test whether the Bargaining Power Hypothesis explains the presence of takeover defenses in the charters of spinoffs, we use SDC and CRSP data to construct a proxy for potential competition among bidders in a sample firm's industry (defined as its 3 digit SIC code). Our proxy is the average number of parties that made friendly or hostile acquisition bids for firms in a sample firm's industry during the five-year period surrounding the firm's IPO, scaled by the number of firms in a firm's industry. If the Bargaining Power Hypothesis is correct, we would expect a negative coefficient on this variable.¹⁰

2. *The Rational Myopia Hypothesis*

As explained above, several theories support the use of takeover defenses as a means of allowing firms to invest in projects whose value is hard to communicate to the market. Stein (1988, 1989), Shleifer and Vishny (1990), DeAngelo and Rice (1983), Knoeber (1986), and Borokhovich, Brunarski & Parrino (1997). Under these theories, managers will be "rationally

¹⁰ In addition, we used a variable measuring the number of friendly or hostile acquisition

myopic” in their investments unless they can resist takeover attempts that are made before the investments come to fruition. Takeover defenses allow managers to resist such attempts.

Rational myopia can occur when two conditions are present: when a firm has investments in long-term projects; and when there is an asymmetry of information regarding the value of those projects. Johnson and Rao (1997) and Pugh, Page and Jahera (1992) use research and development intensity as a proxy for firms with such investments in their analysis of charter amendments. Aboody and Lev (1999) confirm that as R&D intensity increases, so too does information asymmetry. Accordingly, to test the Rational Myopia Hypothesis, we use industry-average R&D intensity as our proxy for the possibility of rational myopia.¹¹ If rational myopia explains the use of takeover defenses, we would expect a positive coefficient on this variable.

3. *Results*

Table 3 presents the results of a matched-pair logit regression, using a size- and industry-matched sample of IPOs. The dependent variable is a binomial variable set equal to one if a firm has a staggered board and 0 if it does not. The independent variable of interest is a dummy variable set equal to 1 if a sample firm is a spinoff and 0 if it is an IPO. The other independent variables are the two controls described above that proxy for bargaining power and the susceptibility of a firm to rational myopia. The coefficient on the spinoff variable is positive and significant at the [.001] level. The coefficient of .76 transforms into a ____ percent greater likelihood that a firm will have a staggered board if it is a spinoff rather than an IPO, while controlling for the possibility that either type of firm has adopted the staggered board for

attempts in a sample firm’s industry without changing the result.

¹¹ We use equal-weighted industry average R & D/Assets in a sample firm’s 3-digit SIC industry over the three-year period immediately preceding the spinoffs. In calculating industry average

efficiency reasons. These results support the hypothesis that staggered boards in spinoffs are associated with management slack in the parent. The next section tests this hypothesis further.

Table 3
Matched-pair logit regression comparing staggered boards in spinoffs and IPOs

Number of bidders	3.3*
R&D/Assets	-2.18
Spinoff dummy	.76***
* significant at .1 level *** significant at .001 level	

B. Factors explaining staggered boards in spinoffs

In order to test further whether the use of takeover defenses in spinoff charters is motivated by a desire to entrench spinoff management, we next analyze the spinoff sample alone. We ran a logit regression with the presence or absence of a staggered board as the dependent variable. Here, we include two sets of independent variables: one set of variables proxy for the degree of alignment between parent manager and shareholder interest and the degree to which parent managers have an interest in entrenching spinoff management, and the second set of independent variables proxy for efficiency-oriented factors that could explain the use of takeover defenses.

1. *Hypothesis 1: Entrenchment Hypothesis*

If entrenchment rather than share-price maximization motivates parent managers to include staggered boards in the charter of their spinoffs, the inclusion of staggered boards should

R&D/Assets, we exclude firms for which Compustat shows missing values for R&D.

increase when senior parent managers themselves are slated to become managers of the spinoff and will therefore benefit personally from the protection provided. To test for this possibility, we create a dummy variable set equal to 1 if parent's CEO, president or chairman became the spinoff's CEO. Data for this variable was obtained from the parent's proxy statement immediately preceding the spinoff.

As an additional test of the entrenchment hypothesis, we include two variables that measure parent managers' share ownership. One variable measures the parent CEO's share ownership and the other measures total parent director and officer share ownership. When parent managers own stock, they will bear a cost of suboptimal governance in the spinoff. Accordingly, if the objective of a takeover defense is entrenchment of spinoff management, we would expect the use of defenses to be inversely related to stock ownership of parent managers.

2. *Hypothesis 2: Efficiency Hypotheses*

We include in this regression the bargaining power and rational myopia variables described above. In addition, we include two variables that could indicate a different source of efficiency that may be specifically related to spinoffs: the possibility that the parent and the spinoff will have business relations with one another that are uniquely valuable to the parent. In light of the fact that the two firms were at one time integrated, it would not be surprising to find that a parent has made firm-specific investments in its spinoff. If that is the case, the parent would lose value if the spinoff is taken over and the relationship is severed. One such scenario would be if a competitor of the parent acquires the spinoff and no longer allows the spinoff to do business with the parent. To test for this source of efficiency, we created two dummy variables. One variable is set to 1 if the parent CEO is on the board of the spinoff a year after the

transaction, and set to zero otherwise.¹² The second dummy variable is set to 1 if there is an overlap in the membership of the parent and spinoff boards. The concept underlying these variables is that if the two firms are going to do business together, some degree of board overlap would be helpful in both guiding and preserving the continuing relationship. Data for these variables are taken from the proxy one year following the spinoff.

3. *Regression Results*

To test these hypotheses, we construct a more complex dependent variable that measures the strength of a takeover defense. The dependent variable has five levels, ranging from strong antitakeover protection to essentially no protection (Daines and Klausner, 2001). The strength of antitakeover protection is defined primarily in terms of the delay that a defense can impose on a hostile acquiror before the acquiror can replace the target firm's board and disable the poison pill or other defenses.¹³ Appendix B describes our variable for the strength of takeover defenses in greater detail. It does not take into account the presence or absence of a poison pill because, as explained above, a pill can be adopted or rescinded by the board of directors at any time, without shareholder approval, whether or not a hostile bid has been made or is imminent. Thus, the current presence of a poison pill does not increase a bidder's marginal cost.

¹² [Create board overlap dummy as well.]

¹³ For each of the regressions reported, we also fit a binary logit model using staggered board as the dependent variable with largely consistent results.

Table 4: Regressions testing Entrenchment and Efficiency Hypothesis
For Takeover Defenses in Spinoff Charters

	model 1	model 2	model 3
Parent CEO share ownership	-.04*	-.03*	-.03*
Parent CEO becomes spinoff CEO	1.4**	1.7**	1.7**
Parent CEO on board of spinoff		-.6**	
Overlapping directors (dummy)			-.33
Number of bidders in industry		1.9	1.8
R&D/Assets		-1.9	2.1
n=151			
* significant at .1 level			
** significant at .05 level			

Table 4 presents the results of three regressions. Model 1 includes only variables related to the Entrenchment Hypothesis, and the results support that hypothesis. Parent CEO ownership is negatively related to the strength of takeover defenses in spinoff charters, implying that the greater the financial stake the parent CEO has, the less likely he is to allow a spinoff to have takeover protection.¹⁴ More revealingly, where the parent CEO, Chairman, or President becomes the CEO of the spinoff, and therefore would benefit directly from takeover protection in the spinoff, the spinoff tends to have stronger takeover protection. This coefficient is significant at the .05 level. Similar results obtained in unreported regressions when we broadened the range of parent managers that became CEOs of the spinoff to include the parent's top 5 highest paid parent employees or board members.

Models 2 and 3 add variables that test the Efficiency Hypotheses as well. In each of these models the coefficients on the variables testing the Entrenchment Hypothesis are essentially unaffected. Thus these models support the Entrenchment Hypothesis. Model 2 tests for an ongoing relationship between parent and spinoff using the dummy variable indicating whether the parent CEO went on the board of the spinoff. Model 3 uses the dummy variable indicating whether there is an overlap in the membership of the boards of the spinoff and parent. Neither model supports the hypothesis that spinoffs are given takeover protection in order to preserve an ongoing valuable relationship. In Model 2, the coefficient is significant but its sign negative rather than positive, indicating that the presence of the parent CEO on the spinoff board is negatively related to the use of takeover protection. In Model 3, the board overlap variable is insignificant. In both Model 2 and Model 3, the coefficients on the bargaining power and R&D variables are insignificant.¹⁵ Thus, the models do not support any of the Efficiency Hypotheses.

In short, we interpret these results as evidence that takeover defenses in spinoffs are adopted out of entrenching, rather than value-maximizing, motivations. When parent managers have incentives to maximize the share value of the spinoff, they tend to avoid entrenching managers of the spinoff. On the other hand, when senior managers of the parent will personally benefit from entrenchment, they are more likely to entrench spinoff managers.

C. Back-Door Charter Amendment? Do spinoffs increase managerial entrenchment?

We next examine whether parent managers include takeover defenses in their spinoffs'

¹⁴ Regressions using parent's total D&O share ownership were the same.

¹⁵ Results are similar when we run the same regressions on only spinoffs in which the parent divested control. We also fit binary logit models for the regressions estimated above, using the adoption of a staggered board as the dependent variable, with consistent results. Hosmer-Lemeshow goodness-of-fit tests fail to reject the hypothesis that these models are a good fit.

charters when the parents' own charters do not have defenses. Doing so would, in effect, amend the charter, without the consent of the shareholders, for the business being spun off. We find that such effective amendments commonly occur. Our results are presented in Table 5. We focus on staggered boards, but the results for voting restrictions parallel these results. Of the 152 spinoff-parent pairs for which we have data,¹⁶ 87 parents (57%) had staggered boards and 65 (43%) parents had nonstaggered boards. Of the 65 parents with nonstaggered boards, 30 (46%) installed staggered boards in their spinoffs. In contrast, of the 87 parents with staggered boards, only 17 (20%) gave their spinoffs nonstaggered boards. Looking at the same phenomenon from another angle, among parents that provided spinoffs with board structures different from their own, 64% (30 out of 47) gave their spinoffs staggered boards, and 36% (17 out of 47) gave their spinoffs nonstaggered boards. To test whether this reflects a statistically significant tendency for parent-to-spinoff changes in board structure to tilt toward staggered boards, we use a McNemar test and find the difference to be highly significant (p-value less than .001).¹⁷

Table 5
Parent takeover defenses relative to spinoff defenses

	Parent has Staggered board	Parent does not have staggered board
Spinoff has Staggered board	70	30***
Spinoff does not have staggered board	17***	35

*** McNemar test significant at .001

¹⁶ There were eight cases in which we could not determine whether a parent firm had a staggered board at the time of the spinoff.

These results are consistent with the concern, raised in the ITT spinoff defense against Hilton's hostile bid. There is no reason to believe that spinoffs are motivated by entrenchment objectives, as in the ITT case. It does appear, however, that parent managers commonly use the opportunity of a spinoff to install an important takeover defense without shareholder approval. These results are economically significant. Spinoffs reallocate a nontrivial portion of the parent's assets to the newly created firm. In our sample, an average of 25% (and a median of 20%) of the parent firm's assets was transferred to the spinoff. In roughly 20% of the sample, the spun off company was actually bigger than the parent firm after the transaction.

We next try to measure the impact of these back-door charter amendments on the share value of parent firms (recalling that the cost of a takeover defense in a spinoff is born by parent shareholders). To measure this impact, we would ideally measure abnormal returns upon the announcement of the spinoffs in our sample, and then compare the abnormal returns for spinoffs that have back-door amendments creating staggered boards with the abnormal returns of those that do not have such back-door amendments. Such a comparison is not possible, however, because when firms announce spinoffs, they do not disclose whether the firm will or will not have a staggered board. Such information instead becomes public later, when the spinoff files a final registration statement with the SEC. It is typical, however, for firms to amend their registration statements one or more times before the registration statement becomes final and the company's shares are sold to the public or distributed to parent shareholders. In some cases, the presence of a staggered board may be disclosed in the first draft of the registration statement, and in others it may be disclosed in a later draft. Consequently, we cannot isolate the time at which information about board structure becomes public.

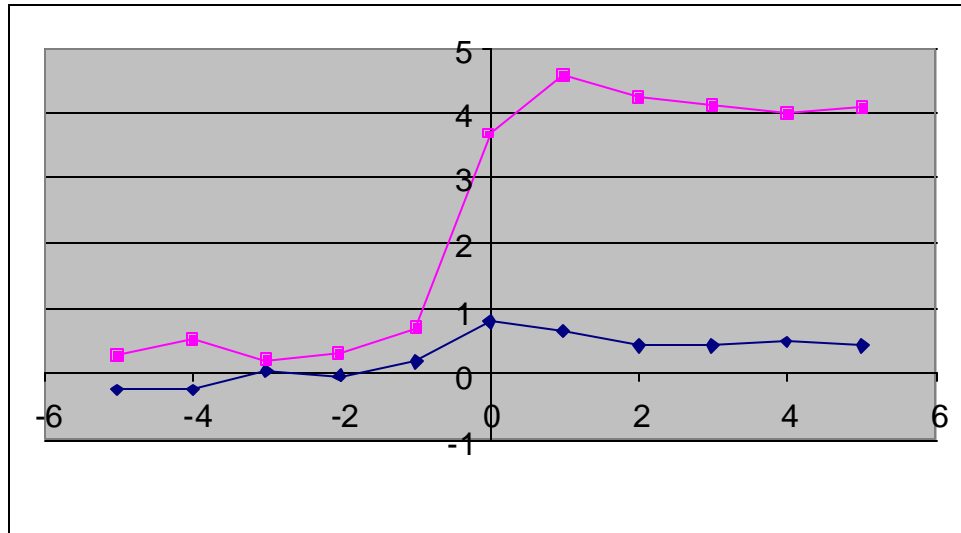
¹⁷ Results are similar and highly significant when we omit [the 54] carve-outs.

We therefore take a less direct approach. We divide the sample into two groups: spinoffs of parents with nonstaggered boards and spinoffs of parents with staggered boards. The first group of spinoffs could adopt back-door amendments that increase entrenchment compared to their parents, while the latter group cannot. The latter group of spinoffs could effect either no change or a reduction in entrenchment. If the imposition of a staggered board is expected to have a negative impact on the spinoff, we would expect abnormal returns for the parents in the first group of firms to be lower than the abnormal returns of parents in the second group.

To measure these abnormal returns, we examine shareholder returns over the 7-day interval surrounding the announcement of the spinoff (from 3 days prior the announcement to 3 days following). Consistent with other studies, we find that spinoffs in general are associated with significantly positive shareholder returns. The cumulative abnormal return (CAR) upon the announcement of the spinoffs in this sample was roughly 4% [and significant at 1%]. Among spinoffs with parents that have staggered boards, CARs 4.8%, and among those with nonstaggered boards, CARs are 1.2%. These results are shown in Figure 1. The difference between the two is significant at the 1% level. This is consistent with the hypothesis that management uses the occasion of a spinoff to impose management-entrenching takeover defense in the charters of their spinoffs.¹⁸

¹⁸ Despite the information problem described above, we did compare spinoffs that ultimately did have staggered boards with those that did not and found no significant difference in CARs.

Figure 1: Comparison of CARs where parents have staggered vs nonstaggered boards



V. Conclusion

When ITT defended itself against an unwanted takeover by Hilton, ITT management attempted to adopt a novel defense: it spun off nearly all its assets into a new corporation that was laden with a staggered board, which ITT lacked and which ITT management could not adopt unilaterally. A federal court rejected this defense, but the attempted maneuver highlights the possibility that low visibility transactions of this sort may be common. When firms spin off subsidiaries, perhaps they routinely entrench the subsidiary's management with takeover defenses.

We investigated this possibility and found that this is indeed the case. Takeover defenses are common in spinoff charters, substantially more common than in IPOs. We further find support for the hypothesis that these defenses are intended to entrench management. Moreover, we find that, as in the ITT case, spinoff charters frequently include more takeover protection than parent's charter provides. Thus the occasion of a spinoff seems to be used as an opportunity to effect the equivalent of a charter amendment with respect to that part of the business being spun off. When this occurs, our findings suggest that the cost of entrenching spinoff management is reflected in parent share prices.

Appendix A

Matching Algorithm

The algorithm we employed to match spinoff firms with similar IPO firms reflects a trade-off between the goal of obtaining matches in similar industries with the goal of obtaining firms that are of similar sizes. We first examined all IPO firms in the same 4 digit SIC code as each spin-off and selected the IPO firm closest in size (as measured by total assets). We then required the IPO firm to have assets no less than 50% and no more than 200% of the spinoff firm's assets. If no firm fit this criteria, we then examined all IPOs in the same 3-digit SIC code and selected as a match the firm whose assets were closest to the sample firm, again requiring that the firm's assets be no less than 50% and no more than 200% of the assets of the spinoff firm. If this procedure did not produce a match, we selected as a match the IPO in firm's 4 digit SIC with assets closest to the spinoff. We could have simply proceeded to examining the firms in the same 2 digit SIC code, but considered this a poor match on industry and preferred to obtain a better industry match if possible even if the size match was worse. We therefore examine all firms in the same 4 digit SIC code and match the spinoff to the IPO closest in size. Failing a match on the 4 digit level, we matched the firm with the IPO in the same 3 digit closest in size. Failing that, we selected the firm in the same 2 (or 1 digit) SIC whose assets were closest to the sample spin-off firm.

Appendix B: Takeover Protection Index

The takeover defense index that we use, first in Table 1 and then as the dependent variable in the regressions shown in Tables ____ and ____, is a 5-level rank ordering of takeover protection. The index is based primarily on the extent of delay that a particular defense or combination of defenses can impose on a hostile bidder's ability to initiate a shareholder vote to replace a target board. For an acquisition to proceed against an unwilling target management—which will have adopted a poison pill—an acquirer must have the target shareholders replace the target board with a slate of directors proposed by the bidder, who will redeem the poison pill. The presence of a poison pill itself is not included in the index because the board of any firm can adopt a pill unilaterally at any time, either before a takeover bid is ever made or in response to a bid. Hence, in effect, all firms have poison pills at all times.

The most restrictive takeover defenses is dual class stock, which puts voting control in the hands of management and therefore can stop an acquisition indefinitely. Dual class stock, however, is rare. In our spinoff sample, only 5.6% of firms have dual class stock. The next most restrictive defense is a staggered board, which requires a bidder to mount proxy fights in two consecutive annual meetings to replace a majority of the board. The next most restrictive defense is a set of restrictions that prevent shareholders from voting at times other than at annual meetings, where their right to vote is mandatory. These restrictions are (a) a prohibition on shareholders calling a special meeting and (b) a prohibition on shareholders voting by written consent.

We treat a staggered board combined with shareholder voting restrictions as more restrictive than staggered board without voting restrictions for two reasons. While dual class stock is more protective than a staggered board with voting restrictions, we combine these

defenses into a single level of the dependent variable because few firms have dual class stock, and treating dual class stock as a separate level produces results that violate the proportionate odds assumption of the cumulative logit model. Aside from this, however, the results of unreported regressions treating dual class stock as a separate level of protection were not appreciably different from those reported here

The second most restrictive level of the dependent variable is a staggered board without shareholder voting restrictions.

The third level down in protection includes firms with charters providing for an annually elected board but with prohibitions on shareholder voting by written consent and calling a special meeting. Shareholders governed by these ATPs must wait until their firm's next annual meeting to replace their board. We also included in this level firms that allow removal of shareholders only for cause. In effect, the directors of these firms cannot be removed by shareholders favoring an acquisition until their term expires at the next annual meeting.

The fourth level down includes firms whose charters provide for annually elected boards and that allow shareholders to call a special meeting or vote by written consent, but also require 90 days or more advance notice for the nomination of board candidates. These provisions impose at least a 90-day delay on a proxy contest. We also include in this level firms with annually elected boards and no restriction of shareholder voting but that are governed by a nonshareholder constituency statute or charter provision. Although the effect of these provisions has not been litigated often, it is possible that the courts will allow a board to rely on them to resist a proxy contest. Placement of these provisions in either the third or fifth level does not appreciably influence our results.

The fifth level—the lowest level of protection—includes firms with no ATPs at all and

those with ATPs that are simply redundant with a poison pill, which any firm can adopt at any time without shareholder approval. Such ATPs include fair price, business combination, and control share acquisition provisions.

The distribution of firms across the five levels of this dependent variable is as follows:

Level (5=most protective)	Frequency (percent)
5	73 (46%)
4	33 (21%)
3	20 (13%)
2	6 (4%)
1	28 (18%)

References

- Aboody, David and Baruch Lev, 1999. R&D and insider gains. Working paper, New York University.
- Baker, Amy J., 1993, Voting by Institutional Investors on Corporate Governance Issues (Investor Responsibility Research Center, Washington, D.C.).
- Berger, Phillip and Eli Ofek, 1995. Diversification's effect on firm value. *Journal of Financial Economics* 37, 39-66.
- Bhagat, S. and Bernard Black, 1999. The uncertain relationship between board composition and firm performance. *Business Lawyer* 54, 921-963.
- Borokhovich, Kenneth A., Kelly R. Brunarski, and Robert Parrino, 1997, CEO contracting and antitakeover amendments, *Journal of Finance* 52, 1495-1517.
- Daines, Robert, 2001. Classified boards and firm value: Takeover defenses after the pill. Working paper, New York University.
- Daines, Robert, 2001. Does Delaware law improve firm value? *Journal of Financial Economics* (forthcoming).
- Daines, Robert and Michael Klausner, 2001. Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs. *Journal of Law, Economics and Organization*.
- DeAngelo, Harry, and Edward M. Rice, 1983, Antitakeover charter amendments and shareholder wealth, *Journal of Financial Economics* 11, 329-360.
- Gertner, Robert and Steven Kaplan, 1996. The Value-Maximizing Board. Working Paper, University of Chicago.
- Grossman, Sanford J. and Oliver Hart, 1982. Corporate financial structure and managerial incentive; in John J. McCall, ed: *The Economics of Information and Uncertainty* (University of Chicago Press, Chicago, Ill.).
- Hart, Oliver and John Moore, 1995. Debt and seniority: an analysis of the role of hard claims in constraining management. *American Economic Review* 85, 567-585
- Jensen, Michael, 1993. The Modern Industrial Revolution, Exit, and the Failure of the Internal Control Systems. *Journal of Finance* 48, 831-80.
- Jensen, Michael C., and William H. Meckling, 1976, Theory of the firm: Managerial behavior, agency costs and ownership structure, *Journal of Financial Economics* 4, 305-360.

- Johnson, Mark S., and Ramesh P. Rao, 1997, The impact of antitakeover amendments on corporate financial performance, *Financial Review* 32, 659-690.
- Klein, April, 1998. Affiliated Directors: Puppets of Management or Effective Directors? Working Paper.
- Knoeber, Charles R., 1986, Golden parachutes, shark repellents, and hostile tender offers, *American Economic Review* 76, 155-167.
- Lipton, Martin and Jay W. Lorsch, 1992. A Modest Proposal for Improved Corporate Governance, *Business Law* 48, 59.
- Pugh, William M., Daniel E. Page, and John S. Jahera, 1992, Antitakeover charter amendments: Effects on corporate decisions, *Journal of Financial Research* 15, 57-67.
- Romano, Roberta. 1992. A Guide to Takeovers: Theory, Evidence, and Regulation. *Yale Journal on Regulation* 9, 119.
- Shleifer, Andrei, and Robert W. Vishny, 1990, Equilibrium short horizons of investors and firms, *American Economic Review* 80, 148-153.
- Stein, Jeremy C., 1988, Takeover threats and managerial myopia, *Journal of Political Economy* 96, 61-80.
- Stein, Jeremy C., 1989, Efficient capital markets, inefficient firms: A model of myopic corporate behavior, *Quarterly Journal of Economics* 104, 655-669.
- Stulz, Rene M., 1988, Managerial control of voting rights: Financing policies and the market for corporate control, *Journal of Financial Economics* 20, 25-54.
- Yermack, David, 1996. Higher valuation of companies with a small board of directors. *Journal of Financial Economics* 40, 185-212.
- Yermack, David, 1997. Good timing: CEO stock option awards and company news announcements. *Journal of Finance* 50, xxxx.
- Wu, Yilin, 2000. Honey, I shrunk the board. Working paper, University of Chicago.

Appendix C

Table 4
Antitakeover provisions present in spinoff and IPO firms

This table compares the use of certain takeover defenses in 160 spinoffs, where agents influence the charter, with a size and industry matched sample of IPOs, where principals are likely to influence the charter. Data regarding the antitakeover provisions are taken from prospectuses of firms conducting spinoff transactions or initial public offerings between 1993-1997, with missing data for some provisions. Firms completing spinoffs and IPOs were identified from SDC data. The details of the matching algorithm are found in Appendix A.

Type of Provision	Present in spinoff firm	Present in matched IPO firm
Dual class stock	5.6%	7.6%
Classified board	64.6	46.2
Shareholders cannot call special meeting or act by written consent ^(a)	52.2	24.1
90 days or more notice for board nomination ^(b)	78.3	55.1
Poison Pill adopted prior to offering	31.7	5.1
Nonshareholder constituency ^(c)	13.7	23.4
Disgorgement	1.9	3.2
Control share acquisition ^(c)		
Fair price ^(c)	31.7	19.6
Business combination (including Delaware's) ^(c)	24.2	27.8
Limits on s/h access to agenda ^(b)		
Percent Delaware companies opting out of business combination statute (§203) ^(d)	10.8	2.0
Percent of non-Del. companies opting out of state antitakeover statutes	25.6	12.7
Blank check preferred stock	95.0	89.9
Total number of firms	160	160

(a) These figures include firms that prohibit shareholders from calling a special meeting altogether. Even among companies in which shareholders are permitted to call a special meeting, there are commonly requirements that a specified percentage of outstanding shares (e.g. 25% or 50%) are needed to do so.

(b) These limits generally take the form of advance notice requirements (often 60 days

and sometimes as many as 130 days) for shareholders to make board nominations or to place an item on the agenda of a shareholders meeting.

(c) With the exception of nonshareholder constituency provisions, the source of almost all of these provisions is the corporation code of the state in which a firm is incorporated..

(d) There are (x) spinoffs and (x) IPO firms incorporated in Delaware.