Shareholder Rights and Managerial Ownership

Implications for Board directors

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I. Introduction: Interactions between Shareholder Rights and Managerial Ownership

A key task of the board of directors is to determine the compensation of top managers. The board usually grants managers stocks and options to alleviate the "agency" problem, by encouraging the managers, who usually do not own the firm, to think like owners. Managerial ownership is supposed to incentivize the managers to work for the shareholders' interest, and this practice has been shown to enhance firm value, at least at low levels of managerial ownership. According to the research, however, too much managerial ownership can damage firm value because it helps entrench the managers with the associated voting power. An entrenched manager is less likely to be replaced, even in the case of poor performance, and thus may be reluctant to exert efforts to increase firm value.

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Consistent with the incentive and entrenchment effects of managerial ownership, the research literature finds a hump-shaped relationship between managerial ownership and firm value, implying that the incentive effect outweighs the entrenchment effect at low levels of managerial ownership, while "entrenchment" dominates "incentive" at high levels of managerial ownership.

Shareholder rights, as measured by antitakeover provisions, also have two effects on corporate governance. On one hand, antitakeover provisions tend to entrench managers by protecting them from takeovers. Consistent with the entrenchment effect of antitakeover provisions, the literature documents a negative association between antitakeover policies and firm value. On the other hand, antitakeover provisions tend to enhance a target firm's bargaining position against the acquirer, and thus raise the bid premium. The literature finds supportive evidence that antitakeover provisions increase bid premium in mergers and acquisitions.

As two central mechanisms of corporate governance, managerial ownership and antitakeover provisions jointly affect a firm's governance. But to date, there has been no study on how they interact with each other. Filling the void, I have tested whether and how antitakeover provisions and managerial ownership interact in affecting managerial incentives and firm value.

II. Research Findings

Using the data of the Standard & Poor's 1500 firms over the period 1992 to 2007, I found that managerial ownership enhances firm value in companies with weak antitakeover provisions, but damages firm value in those with strong antitakeover provisions. In terms of economic significance, each 10% increase in managerial ownership raises Tobin's Q – the ratio of the market value to the book value of a firm – by 9.4% for firms with weak antitakeover provisions, while each 10% increase in managerial ownership reduces Tobin's Q by 6.3% for firms with strong antitakeover provisions. Antitakeover provisions protect managers from takeovers and thus hinder shareholders' rights. The findings indicate that the incentive effect of managerial ownership outweighs the entrenchment effect of managerial ownership when shareholders' rights are strong, while the opposite is true when shareholders' rights are weak.

The implication is that the voting rights of managerial ownership are more important when shareholder rights are weak, and consequently the entrenchment effect of managerial ownership outweighs its incentive effect with weak shareholder rights. I also find that antitakeover provisions decrease the stock returns around the announcement of manager share purchases in the open market. These findings suggest that antitakeover provisions decrease the value effect of managerial ownership, and that the market implicitly understands the interactions between antitakeover provisions and managerial ownership.

Why does the effect of managerial ownership on firm value depend on the strength of antitakeover provisions? There are two possible reasons. First, antitakeover provisions intensify the entrenchment effect of managerial ownership. For example, with a staggered board, managers can use their voting power over more than one year to prevent a raider from replacing the directors who do not agree with the acquisition. Second, antitakeover provisions weaken the incentive effect of managerial ownership. Antitakeover provisions increase the target firm's bargaining position against the acquirer, and thus increase the proportion of the synergy gains that accrues to the target firm. Synergy increases when the target managers exert less effort. Therefore, antitakeover provisions induce the target managers to exert less effort – i.e., decrease the incentive effect of managerial ownership – all other things being the same.

If the board of directors and the shareholders understand the negative impact of antitakeover provisions on the value effect of managerial ownership, you'd expect that companies with strong antitakeover provisions would grant fewer stocks to managers. Consistent with this prediction, I find that managerial ownership decreases significantly with the strength of antitakeover provisions. On average, the combined ownership of the top five executives is 7.6% in the firms with the weakest antitakeover provisions, and 2.1% in the firms with the strongest antitakeover provisions.

In summary, I found that antitakeover provisions decrease the value effect of managerial ownership.

> ***The impact of antitakeover provisions is so great that managerial ownership destroys firm value when antitakeover provisions are strong.***

The impact of antitakeover provisions on the value effect of managerial ownership is so great that, as we've seen, managerial ownership destroys firm value when antitakeover provisions are strong.

III. Implications for Boards of Directors

From 1992 to 2009, the median CEO compensation of the S&P 500 companies increased by 250%. During the same period, the S&P stock index increased by 150%, while the median profits of these firms increased by merely 60% (Figure 1). The drastic increase in CEO compensation is mainly attributable to the increase in grants to management of stocks and stock options. From 1992 to 2009, the median stocks and options grants to the CEOs of the S&P 500 firms increased by more than 10 times (Figure 2). As a result, the proportion of stocks and options in the total compensation of a typical CEO has doubled during this period, from about 30% to 60% (Figure 3).

The popularity of stocks and options stems from the belief that they help align the interest of the manager with that of the shareholders. My findings suggest that this belief is not always true. When shareholders' rights are weak, managerial ownership destroys firm value. The findings suggest that directors should not grant stocks or options to the managers when shareholders' rights are weak.

My findings also indicate that shareholders' rights and managerial ownership are complementary governance mechanisms. Therefore, directors should strive to balance shareholders' rights and managerial ownership when designing their corporate-governance mechanisms.

Figure 1:
S&P 500 CEO Pay, Stock Return, Corporate Profit, and Inflation 1992-2009 (1992 = 100). CEO compensation data from Thomson Reuters ExecuComp database. Stock returns from the CRSP database; corporate profits from Compustat; inflation data from the Federal Reserve Board website.

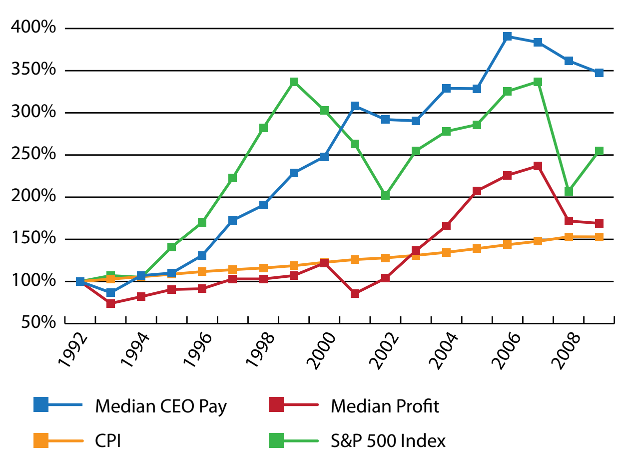


Figure 2:
Median CEO Compensation in the S&P 500 Companies, 1992-2009 (in 2009 dollars). Compensation data from the Thomson Reuters ExecuComp database.

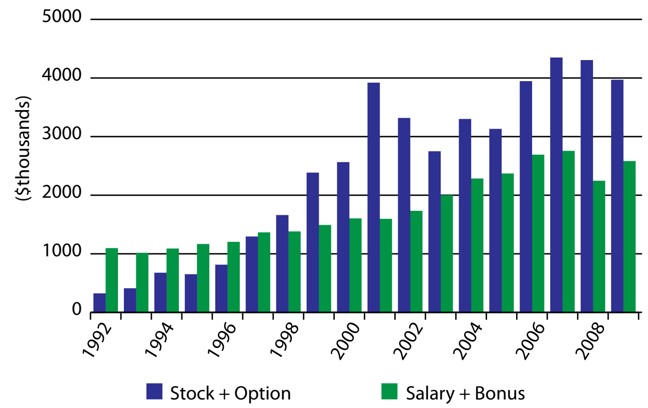
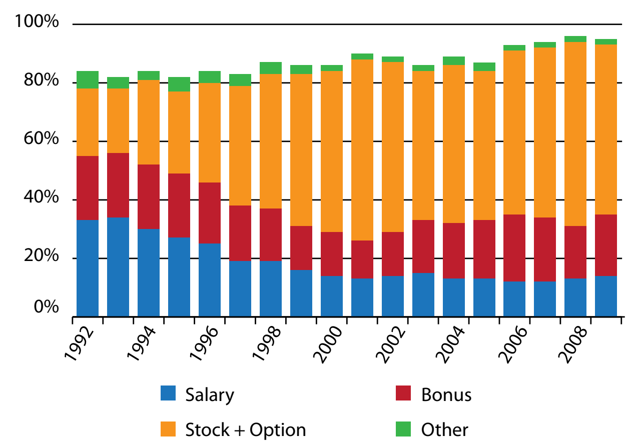


Figure 3:
Median CEO Pay in the S&P 500 Companies, 1992-2009. CEO compensation data from the Thomson Reuters ExecuComp database.



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