

PROXY CONTESTS

Summary of paper by Mulherin and Poulsen:

The theory of the firm attributes the survival of the corporate form to devices such as proxy contests that constrain the potential incentive problems created by the separation of ownership and control. Alchian and Demsetz (1972, p. 97) state that "... the transfer of proxies enhances the probability of decisive action in the event current stockholders or any outsider believes that management is not doing a good job with the corporation." The maintained hypothesis is that proxy contests are a weapon in the war against agency costs. However, an alternative hypothesis is that proxy contests are merely a battle between one set of hogs at the trough and another. The empirical question is, Do proxy contests increase stock holder wealth?

Table 1 shows the prior research. There has been a good bit of work done. The results are mixed and some seem likely to be in error. No one has looked at the period of the announcement through the aftermath (i.e., a year or so following the contest). The aftermath is important because the proxy contest is a method for changing the management of a firm in order to improve performance. However, a proxy contest does not itself cause management to be improved, it is merely the first step. Hence, the market reaction to the change may occur after the contest is over because only then, in some cases, will it become clear that managerial changes have indeed occurred.

Sample comprises 270 proxy contests for board seats in the 1979-94 period. Two data sources to create the sample: contests in the 1979-89 period are derived from the list of proxy solicitations (Schedule 14b) filed with the Securities and Exchange Commission (SEC) while contests in the 1990-94 period are taken from the Proxy Fight Database of the Securities Data Company (SDC). For each of these data sources, we exclude firms not having stock returns on the Center for Research in Security Prices (CRSP) files on NYSE/Amex or Nasdaq firms. Drop proxy solicitations that are not for board seats and firms with no mention of the occurrence of a contest in the *Wall Street Journal* or on the *Dow Jones News Retrieval Service*. The Appendix provides more detail on our sample formation procedure.

Table 2 reports the annual occurrence of the sample contests. The 270 contests in the 16-year sample period imply an average of 17 contests per year. For the first five years of the sample, 1979 to 1983, the annual number of contests is below this average, ranging from ten to 13. The annual number of contests increases in the second half of the 1980s and peaks at 37 contests in 1989. From this level, the rate of contests declines in the 1990s, averaging 16 contests per year in the 1990-94 period.

Table 3 reports descriptive statistics of the proxy contest sample. This information allows us to benchmark the characteristics of the contests in our sample relative to prior research and to determine the extent to which the underlying attributes of the sample firms change over time. Details regarding the material used to determine the attributes of the sample contests are reported in the Appendix.

To study proxy contests over time, Table 3 also reports data for three subperiods: 1979-83, 1984-89, and 1990-94. The analysis of separate time periods addresses whether the nature of proxy contests has changed in response to alterations in the underlying corporate governance environment as evidenced by judicial decisions such as the validation of poison pills [*Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985)] and second-generation control share statutes [*CTS Corporation v. Dynamics Corporation of America*, 481 U.S. 69 (1987)]. The

specific years for the subperiod analysis are motivated by the fact that 1984 marks the first occurrence of a poison pill at a sample firm and 1989 spells the decline of an active market for corporate control documented by Comment and Schwert (1995). The separate analysis of the 1990-94 period also controls for the use of two different source materials, the SEC and SDC.

Prior research finds that firms experiencing proxy contests exhibit poor performance. Consistent with these findings, the firms in M&P sample have a poor record of paying dividends. As reported in Panel B of Table 3, only 35% of the sample firms pay a steady dividend in the period from three years prior to two years following the contest. Thirty-nine percent of the sample firms pay no dividend at all during the period surrounding the contest, 20% omit a dividend in the three years prior to the contest, and 6% omit a dividend within the two years following the contest. The dividend record of the sample firms is similar across the three subperiods reported in Table 3. DeAngelo and DeAngelo (1990, pp. 1417-1418) cite evidence that "annual dividend decreases are uncommon, with increases surpassing decreases by a factor of 15 or 20 to one." The fact that only one-third of M&P firms pay a steady dividend indicates substandard performance.

Dissidents accumulate a sizable fraction of the common stock of the target firms, with a median dissident stake (reported in Table 3) of 9.1%. This stake ranges between 7.6% and 9.8% across time periods. The dissident stake is comparable to the 10% figure reported in prior studies such as Borstadt and Zwirlein (1992) and Ikenberry and Lakonishok (1993).

Proxy contests are routinely classified according to the fraction of seats sought by the dissidents. As reported in Table 3, dissidents seek to attain a majority or more of the total board seats of the target firm roughly two-thirds of the time. The fraction of contests for full control is similar across time periods and resembles the rate reported in prior research.

Table 3 also indicates that 43% of the sample contests are accompanied by an outright takeover bid. This fraction varies across time periods, ranging from 29% in the 1979-83 period to 52% in the 1984-89 period. This variation is consistent with the view that the changing corporate governance environment has induced a growing complementarity between proxy contests and outright takeover bids. As further evidence of an alteration in the underlying governance environment, Table 3 reports an increase over time in the fraction of firms having a poison pill from zero in the 1979-83 period to 42% in the 1984-89 period. By the 1990s, 62% of the firms in the sample employ a poison pill at the time of the contest.

Panel C of Table 3 reports information on the governance results of the sample contests. A commonly reported statistic is the fraction of cases in which dissidents attain seats. Dissidents gain seats roughly half of the time. This rate is similar across time periods and resembles that reported in prior research.

M&P examine actual changes at target firms by measuring the rate at which the most senior officer, normally the CEO, is replaced and the fraction of cases in which the target firm is acquired proximate to the proxy contest. Find that the senior officer is replaced 61% of the time, with similar rates of management turnover in the three subperiods. For the full sample, 23% of the firms are acquired, with the greatest rate of acquisition, 27%, occurring in the 1984-89 period.

Table 4 shows that proxy contests on average improve stockholder wealth. The net share price change over the entire contest period and aftermath is given in the first row. It is the sum of 5.35% and -3.43%. Panel B shows a slightly different estimate. Thus, the gain to share holders is somewhere between 2 and 4 percent.

Tables 7 and 8 break the shareholder effects down based on the way the contest was waged and the outcome. When the proxy battle was fought along with a takeover attempt, shareholders gain a lot if the takeover is successful, but lose mightily if the takeover attempt is thwarted. This is understandable. If both of the main weapons in the war against agency costs are employed and the victory is not achieved, the shareholders are in dire straights. Panel B of Table 7 shows the effect if no takeover is attempted. These results are mixed, but generally say that there is a very modest increase in value regardless of whether the contest is successful.

Panel C of that table shows an interesting result. In 25 cases where the contest is not successful, managerial turnover is achieved anyway, and stockholder wealth increases by about the same amount as occurs in a successful proxy fight culminating in a takeover. When managerial turnover occurs even though the proxy fight is lost, we can only assume that the board was inspired by the contest to make changes.

To summarize the source of wealth gains, M&P partition the data in a 2 x 2 framework according to whether the firm is acquired and whether senior management is replaced. For each of the four possible categories, we report CARs for the full sample of contests for the period from 20 days prior to contest initiation to contest resolution and for the one year following the contest. CARs are estimated using simple compounding and the CRSP equally weighted index, although similar results obtain using other estimation procedures.

The results of this analysis are presented in Table 8. The data indicate that corporate acquisitions are the driving force behind shareholder wealth gains in proxy contests. As reported in Panel A, regardless of whether senior management is replaced, the 63 contests that induce an acquisition of the target firm are associated with a large positive increase in shareholder wealth during the full contest period. As reported in Panel B, this gain is sustained following the contest with a nonnegative post-contest change in shareholder wealth for the firms that are acquired.

For the 197 firms that are not acquired, the change in shareholder wealth is a function of whether or not senior management is replaced. As reported in Panel A of Table 8, the 122 firms that are not acquired but that replace senior management experience an abnormal wealth increase of 6.96% ($z = 3.57$) in the full-contest period. By contrast, the firms that retain senior management experience a negative, insignificant change in shareholder wealth over the full-contest period. As reported in Panel B of Table 8, the firms with management turnover have an insignificant wealth change in the year following the contest. By contrast, the firms that do not replace management experience a negative and significant wealth change of -20.1% ($z = -3.38$) in the post-contest period.

In the case where management is not changed though a takeover is achieved, the wealth gains to shareholders may arguably be the result of improved managerial monitoring or, alternatively, synergies with the acquiring firm.

M&P results on the important complementary role between proxy contests and outright takeover bids can be viewed as one realization of Roe's (1993, p. 393) prediction of the use of "a new technology to overcome the [growing trend in] antitakeover laws." In effect, proxy contests can turn a hostile tender offer into a friendly deal by removing incumbent management who might otherwise use the terms of poison pills or the provisions in state laws to block an acquisition. The ability of proxy contests to facilitate tender offers suggests one reason for Comment and Schwert's (1995) finding that the growing occurrence of hurdles to tender offers did not systematically deter corporate control transactions in the 1980s.