

Classified Boards, Stability, and Strategic Risk Taking

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Classified boards are the focus of recent shareholder activism aimed at improving U.S. corporate governance. Although critics argue that classified boards reduce directors' effectiveness, proponents counter that they enhance corporate stability, board independence, and long-term strategic risk taking. Based on hand-collected data, this study found that stability was similar for both classified and nonclassified boards and that continuity rates for independent directors were comparable for both categories. The study found as well that companies with classified boards invested less in R&D and other company-specific capital assets. These findings were also true for companies with relatively complex operations that are often considered most likely to benefit from classified boards.

A basic tenet of U.S. corporate democracy is the right of shareholders to elect directors. The default law in all states, with the exception of Massachusetts, requires directors to be elected for one-year terms at the corporation's annual meeting.¹ All states, however, also permit corporations to have classified boards, whereby directors are divided into groups, or classes (usually three), with each group elected at successive annual meetings and directors serving overlapping, multiyear terms. Thus, approximately one-third of all directors stand for election each year, and each director is reelected roughly once every three years.²

Recently, classified boards have come under widespread attack by shareholder activists and institutional investors. According to Institutional Shareholder Services (ISS 2006), 46 shareholder proposals to declassify boards received an average of 60.5 percent favorable votes in 2005; that number increased to 66.8 percent for 42 such proposals voted on by 30 June 2006. ISS itself recommends voting against proposals to classify boards and in favor of proposals to repeal classified boards and elect all directors annually. Similarly, the California Public Employees' Retirement System (CalPERS) recommends annual election of all directors as part of its U.S. Corporate Governance Core Principles and Guidelines.

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By staggering the election of directors, classified boards impede nonfriendly transfers of control, because a hostile acquirer must wait at least two annual meetings before gaining control of the board even if it controls a majority of the corporation's outstanding shares. Critics argue that this hindrance harms investors by encouraging managerial entrenchment and diminishing directors' accountability to shareholders. In recommending a vote against classified boards, ISS (2003) argued that they tip "the balance of power too much toward incumbent management at the price of potentially ignoring shareholder interests."³ Similarly, CalPERS argued in its 2004 shareholder proposal to declassify Ingersoll-Rand Company's board of directors that classified boards work "primarily to hamper accountability."

These claims are often based on two types of studies: those that examined the stock price reaction to adoptions of classified boards and those that analyzed the impact of classified boards on hostile-takeover activities. The first group of studies showed that stock prices generally decline when companies announce the adoption of classified boards; the second group found that classified boards significantly increase the odds that a hostile target will remain independent and that higher premiums do not result if the target is acquired.⁴

Although these studies suggest that classified boards are harmful to shareholder interests, classified-board proponents (e.g., Wilcox 2002) contend that any antitakeover effects serve only to increase management's bargaining power by

allowing the target's board both adequate time and the perspective to evaluate bids accurately and to solicit competing offers. Furthermore, proponents argue that classified boards promote board independence: Directors elected to multiyear terms are less subject to executive influence because they are unconcerned about annual renomination. More important, they argue, classified boards enhance board and corporate stability by ensuring that a majority of directors always have prior experience as directors of the company in any given year. This is presumed to enhance the board's ability to focus on long-term strategy and performance, especially for companies with relatively complex operations.⁵

As previously noted, the question of whether shareholders benefit from the antitakeover effects of classified boards has been the subject of empirical research. In contrast, no hard evidence exists on the non-takeover-related justifications for classified boards. For instance, do companies with classified boards have more stable boards with less director turnover? Do they invest more in long-term, company-specific assets? Do classified boards enhance the ability of companies with relatively complex operations to create value for their shareholders? These issues are significant, and an understanding of them promises to inform the debate on classified boards.

In this study, I used hand-collected data for 1995–2002 for a sample of 2,072 companies to examine these issues. First, I analyzed the effect of classified boards on long-term board stability. Next, I examined the effect of classified boards on corporate investments in long-term, company-specific capital assets. Finally, I analyzed the effect of classified boards on wealth creation among companies that are subject to a high degree of operating uncertainty.

Sampling and Data

I started with the 3,823 definitive proxy statements filed through EDGAR with the U.S. SEC in 1995. From this group, I removed duplicate filings and filings by mutual funds, real estate investment trusts, limited partnerships, subsidiaries, and companies with incomplete data in Standard & Poor's Compustat, which reduced the sample to 2,166 companies. After reading through each proxy statement, I identified 1,083 companies with classified boards. I then checked subsequent proxy statements for each of these companies from 1996 through 2002 to identify 32 companies that declassified their boards during this period. Similarly, I examined succeeding proxy statements for companies without classified boards in 1995 and identified 62 companies that subsequently classified their boards. I removed both categories of companies to

ensure that each company in the final sample had either a classified or a nonclassified board throughout the empirical window I analyzed. This process produced a final sample of 2,072 companies, of which 1,051 (or slightly more than 50 percent) had classified boards and the remaining 1,021 had nonclassified boards.

I collected detailed data on the directors of each company as reported in the 1995 proxy statement. The companies had a combined 18,491 directors, with an average of 8.9 directors per company. I grouped directors into two categories: affiliated and independent. Affiliated directors are employee directors or nonemployee directors who had personal or business relationships with the company or any of its employees. Independent directors are nonemployee directors having no business or personal relationships with the company or any of its employees. **Table 1** presents descriptive statistics for directors and boards and shows proxy-statement data on the ownership and leadership structure of each company. Table 1 also shows summary statistics for other variables used in later tests. All financial variables were obtained from Compustat and averaged over 1995–2002.

Classified Boards and Board Stability

I defined board stability as the proportion of 1995 directors remaining on the board in 2002. To obtain this number, I compared each company's 1995 director slate with its directors as reported in its 2002 proxy filing. Thus, if a company had 10 directors in 1995 and 7 of them remained on the board in 2002, its board-stability value would be 70 percent. I calculated similar measures for the two director categories (affiliated and independent) to determine whether classified boards had different effects on the two categories. Results of these univariate comparison tests are summarized in **Table 2**, which shows no statistically significant differences. Thus, the evidence based on univariate comparisons does not support the claim that staggered elections enhance board stability and director continuity. On the contrary, the opposite appears to be the case.

Of course, board stability is probably affected by factors other than the manner in which directors are elected. For instance, Crutchley, Garner, and Marshall (2002) showed that directors are more likely to leave following poor company performance; Yermack (2004) reported that director turnover was affected by director age and gender. Similarly, basic intuition and anecdotal evidence suggest that director reshuffling occurs following CEO turnover because the new CEO invites fresh candidates to the board. In addition, the company's

Table 1. Summary Statistics, 1995–2002

Variable	Sample Size	Mean	Median	Std. Dev.
Director age	18,491	58.67	59.00	9.74
Director tenure in years	18,491	9.87	8.00	8.97
Female directors	18,491	6.1%	0.0%	24.0%
Directorships	18,491	1.46	1.00	0.94
Board size	2,072	8.94	9.00	3.40
Affiliated directors	2,072	43.6%	40.0%	16.6%
Independent directors	2,072	56.4%	60.0%	20.5%
Independent nominating	2,072	26.9%	0.0%	44.4%
Managerial ownership	2,072	21.0%	13.2%	21.0%
Block ownership	2,072	10.4%	7.3%	11.6%
Unitary leadership	2,072	68.1%	100.0%	46.6%
Same CEO	2,045	66.9%	100.0%	47.0%
Delaware incorporation	2,072	46.6%	0.0%	49.9%
Poison pill	2,072	49.3%	0.0%	50.0%
Proxy fight	2,072	4.7%	0.0%	21.2%
Leverage	1,882	19.3%	16.7%	18.9%
Company size	1,883	6.01	6.0	2.2
Profitability	1,878	12.7%	13.4%	12.7%
Tobin's <i>q</i>	1,871	1.44	1.00	1.82

Notes: *Directorships* is the number of corporate boards on which the director served. *Board size* is the number of directors. *Affiliated directors* are employee directors and nonemployee directors who had personal or business relationships with the company or any of its employees. *Independent directors* are nonemployee directors having no business or personal relationships with the company or any of its employees. *Independent nominating* equaled 1 when the company had a nominating committee of which the CEO was not a member and 0 otherwise. *Managerial ownership* is the proportion of the company's shares owned by officers and directors. *Block ownership* is the proportion of shares owned by unaffiliated holders of 5 percent or more. *Unitary leadership* equaled 1 when the CEO also served as board chairman and 0 otherwise. *Same CEO* equaled 1 when the CEO remained unchanged over 1995–2002. *Delaware incorporation* equaled 1 if the company was incorporated in the state of Delaware and 0 otherwise. *Poison pill* equaled 1 if the company had a poison pill and 0 otherwise. *Proxy fight* equaled 1 if the company was the target of a proxy fight between 1995 and 2002 and 0 otherwise. *Leverage* is the ratio of long-term debt to total assets. *Company size* is the natural logarithm of total assets in 1994 constant dollars. *Profitability* is the ratio of operating income before depreciation to total assets at the beginning of the year. *Tobin's q* is the ratio of the sum of market value of common equity, book value of preferred equity, and book value of long-term debt to the book value of assets. All financial variables were averaged over 1995–2002.

Table 2. Univariate Comparison of Board Stability: Classified vs. Nonclassified Boards, 1995–2002

Variable	Nonclassified Boards	Classified Boards	<i>t</i> -Statistic
All directors	60.5%	58.9%	1.400 (0.163)
Affiliated directors	61.1	58.8	1.510 (0.132)
Independent directors	59.5	59.5	0.020 (0.983)

Notes: *Board stability* is the proportion of 1995 directors that remained on the board in 2002. Directors serving on nonclassified boards were reelected annually; directors serving on classified boards were reelected on a staggered basis—usually once every three years.

ownership structure may affect the balance of power among the CEO, other directors, and institutional or other significant shareholders, thereby influencing board stability by affecting the likelihood of certain directors' being renominated to the board.

Consequently, in estimating regressions, I controlled for these and other factors that might affect board stability. I used profitability as a proxy for company performance, and I measured director gender and director age as the percentage of female directors and the average age of all directors, respectively. Furthermore, I controlled for the percentages of each company's outstanding shares owned by officers and directors and by unaffiliated owners of at least 5 percent each. I also controlled for a host of other variables, which are described in the notes to Tables 1 and 3.

As **Table 3** shows, the evidence is inconsistent with the notion that staggered elections promote board stability. After controlling for other factors, I found that the classified-board variable was not significant in the regression for all directors, which indicates that classified boards are no more stable than nonclassified boards. Similarly, classified boards were not significantly related to board stability as measured by the continuity rates of affiliated directors or independent directors. The latter result suggests that electing directors to staggered terms does not enhance board independence through the retention of independent directors.

Although these results contradict the position of classified-board proponents, they are not entirely surprising. Specifically, that a classified board is needed to ensure board stability is not obvious, because most companies nominate the same slate of directors year after year. In promoting a classified board to shareholders in its 2002 proxy statement, the William Wrigley Jr. Company conceded as much when it stated that “the Company has not experienced such continuity problems in the past.” Fittingly then, these results confirm what one would expect from an observation of the director nomination and election processes at most companies.

Other findings in **Table 3** are mostly consistent with that expectation. The positive coefficients on managerial ownership imply that, in this study, board stability increased with directors’ equity ownership. Similarly, the board was more stable if the company’s CEO remained at the helm and less stable if the company was involved in a proxy contest or had an independent nominating committee. Board stability also decreased with directors’ age and board size but increased with directors’ tenure. I found no significant effects, however, for poison pills and Delaware incorporation—two characteristics designed to thwart hostile takeovers. Also, in unreported regressions, I found that the combination of a classified board and a poison pill had no significant effect on any of the measures of board stability.⁶

Robustness Checks. A potential concern with my results is whether my measures of board stability are contaminated by directors leaving the board after 1995 and returning by 2002. If that were the case, my board-stability measures would inflate the true board stability. I investigated this possibility by constructing detailed board-service histories for directors to see whether they left the board at any point after 1995 and rejoined by 2002. Because of the costs and labor of manual data collection, I restricted

my analysis to a random subsample of 2,063 directors of the 18,491 directors in my full sample. These directors represent 223 of the 2,072 sample companies. I found that none of these directors left the board and rejoined at a later time during my sample period. Thus, my board-stability measures are unlikely to have been affected by this concern.

I also analyzed the sensitivity of my results to the length of time over which board stability was measured by defining stability measures for 1995–1999 instead of 1995–2002. Thus, I redefined full board stability as the proportion of all 1995 directors that remained on the board as of 1999, and I created analogous stability measures for both affiliated and independent directors. I obtained these new measures by comparing each company’s 1995 director slate with its directors as reported in its 1999 proxy filing. To reduce the costs of manual data collection, I restricted my analysis to the random subsample of 2,063 directors.

Using these new measures, I found that an average of 72.6 percent of all 1995 directors remained on nonclassified boards in 1999, compared with 70.8 percent for companies with classified boards. The difference is statistically insignificant. Similarly, I found that an average of 73.9 percent of 1995 affiliated directors remained on nonclassified boards by the end of 1999 versus 70.6 percent for classified boards. Again, the difference is not statistically significant. Moreover, I found no significant differences between classified and nonclassified boards in terms of the redefined continuity rates for independent directors: 72.9 percent for nonclassified boards and 70.3 percent for classified boards. In addition, using the new stability measures, I estimated regressions and obtained results quite similar to those reported in **Table 3**. Overall, these findings suggest that the results presented in **Table 3** are not sensitive to the length of time over which board stability is measured.

Finally, I analyzed the sensitivity of my results to potential multicollinearity, especially between board size and company size, which are highly correlated ($\rho = 0.65$). I followed the traditional approach for addressing multicollinearity by estimating alternate regressions that included both variables, one variable at a time, and neither variable. The results, unreported here, suggest that my basic findings are robust to this concern. Specifically, classified boards had no significant effect on board stability in each regression, and the coefficients, p -values, and adjusted R^2 s are similar across the regressions.

Table 3. Classified Boards and Board Stability, 1995–2002
(robust standard errors in parentheses)

Variable	All Directors	Affiliated Directors	Independent Directors
Classified board	0.0133 (0.010)	0.0159 (0.012)	0.0187 (0.015)
Board size	-0.0089*** (0.002)	-0.0131** (0.002)	-0.0050** (0.003)
Board independence	0.0481* (0.029)	0.1233*** (0.032)	0.0129 (0.044)
Managerial ownership	0.0006** (0.000)	0.0008** (0.000)	0.0004 (0.001)
Block ownership	0.0007 (0.001)	0.0003 (0.001)	0.0006 (0.001)
Unitary leadership	0.0001 (0.011)	-0.0135 (0.013)	-0.0025 (0.015)
Same CEO	0.2612*** (0.011)	0.4805*** (0.014)	0.1528*** (0.016)
Independent nominating	-0.0207* (0.012)	-0.0249* (0.014)	-0.0251* (0.016)
Average director age	-0.0085*** (0.001)	-0.0046*** (0.002)	-0.0115*** (0.002)
Board tenure in years	0.0061*** (0.001)	0.0060*** (0.002)	0.0044** (0.002)
Percentage female directors	-0.0705 (0.071)	-0.0469 (0.077)	-0.1165 (0.103)
Average directorships	0.0172 (0.013)	0.0012 (0.016)	0.0043 (0.017)
Delaware incorporation	0.0060 (0.010)	0.0231** (0.012)	0.0006 (0.014)
Poison pill	-0.0157 (0.011)	-0.0095 (0.014)	-0.0020 (0.016)
Proxy fight	-0.0432* (0.025)	-0.0898*** (0.027)	-0.0201 (0.034)
Leverage	-0.0180 (0.028)	0.0187 (0.034)	-0.0395 (0.051)
Company size	0.0005 (0.004)	-0.0045 (0.005)	0.0034 (0.006)
Operating performance	0.0872* (0.046)	0.0603 (0.049)	0.1207* (0.068)
Intercept	0.8446*** (0.100)	0.5461*** (0.118)	1.1373*** (0.128)
Adjusted R ²	0.341	0.524	0.109
Sample size	1,852	1,852	1,821

Notes: The dependent variable in these regressions is the proportion of 1995 directors remaining on the board in 2002. The variables are defined in the notes to Table 1. Financial variables were averaged over 1995–2002. Each regression included two-digit primary SIC code dummies to control for unobservable industry factors. Robust standard errors are based on White (1980) to account for potential heteroscedasticity.

*Significant at the 10 percent level.

**Significant at the 5 percent level.

***Significant at the 1 percent level.

Classified Boards and Strategic Risk Taking

Classified boards are often promoted as enhancing directors' ability to focus on long-term strategy. The basic argument is that because classified boards guarantee directors longer terms in office, directors are shielded from the effects of short-term fluctuations in company fortunes, which allows them to focus on long-term strategic issues. I evaluated this argument by analyzing the effect of classified boards on capital investment, especially in R&D and long-term physical assets.

I chose R&D because of its long gestation period and the relatively high level of uncertainty associated with its expected payoff, which is largely company specific. Thus, if staggered elections afford directors a long-term perspective, companies with classified boards should, all else being equal, invest more resources in R&D. I analyzed investment in physical assets to check for robustness.

I defined *R&D* as the ratio of R&D expenditures to total assets, and investment in physical assets as the ratio of net capital expenditures on property, plant, and equipment (PP&E) to net PP&E at the beginning of the year (denoted *DK/K*), with both ratios averaged over the sample period. I found that classified boards invested significantly less in R&D than did nonclassified boards during this period. On average, companies with classified boards invested 2.1 percent of their assets in R&D, compared with 4.3 percent for companies with nonclassified boards. The difference is statistically significant at better than the 1 percent level. Similarly, companies with classified boards invested an additional 19.8 percent in long-lived physical assets, compared with 20.6 percent for companies with nonclassified boards, although the difference is not statistically significant.

I estimated regressions relating my measures of capital investments to classified boards, controlling for other variables that might affect corporate investments in capital assets (industry characteristics, profitability, leverage, company size, and other dimensions of corporate governance as defined in Table 1). Because more than 60 percent of the companies in my sample had zero R&D investment, I estimated two regressions for *R&D*. The first is a Tobit regression for the full sample; the second is an ordinary least-squares (OLS) regression for companies that invested in R&D. Results of these regressions and the regression for *DK/K* are presented in **Table 4**.

As Table 4 shows, the coefficient on classified boards is negative and statistically significant in both *R&D* regressions. The coefficient estimated for

the full sample (*R&D* with other factors controlled for) indicates that classified boards are associated with a reduction of 1.57 percentage points in R&D spending. Because R&D expenditures averaged 3.2 percent of total assets for the full sample, this reduction is economically significant. Similarly, the *DK/K* regression shows that classified boards reduced investment in long-term physical assets by 1.22 percentage points, although this finding is only marginally statistically significant (p -value = 0.11). Nevertheless, a reduction of 1.22 percentage points is economically nontrivial compared with the sample average capital-investment rate of 9.6 percent.

To test whether the combination of a classified board and a poison pill strengthened the effects of classified boards on long-term strategic investments, I estimated additional regressions (unreported here) that included an interaction term for poison pills and classified boards. I found that the interaction term was not significant in the regression for either *R&D* or *DK/K*. Thus, the combination of a classified board and a poison pill appears to have no significant effect on corporate investments in long-term, company-specific assets.

These results are difficult to reconcile with the notion that classified boards enhance a company's ability to focus on long-term strategy. Also, they are not consistent with the idea that classified boards are beneficial to shareholders. McConnell and Muscarella (1985) and Chan, Martin, and Kensinger (1990) showed that stock prices tend to rise when companies announce increases in corporate capital budgets, in general, and R&D spending, in particular. Similarly, Eberhart, Maxwell, and Siddique (2004) showed that over the long term, companies that increase their R&D spending subsequently achieve significantly higher operating performance than companies that do not. These studies suggest that shareholders typically want companies to undertake more long-term investing. Of course, companies with classified boards may simply cut back on capital spending and R&D when doing so is optimal. The significantly lower value creation associated with classified boards, however, undermines such an interpretation.⁷

Classified Boards in Complex Companies

One outcome of the recent trend toward prescribed corporate governance is the effort to identify situations in which certain classes of companies benefit from governance provisions that are conventionally regarded as harmful. Notwithstanding my previously presented results, I decided to consider the

Table 4. Classified Boards and Long-Term Investment, 1995–2002
(robust standard errors in parentheses)

Variable	<i>R&D I</i>	<i>R&D II</i>	<i>DK/K</i>
Classified board	−0.0157*** (0.006)	−0.0152*** (0.005)	−0.0122 (0.009)
Board size	−0.0037*** (0.001)	−0.0049*** (0.001)	−0.0081*** (0.002)
Board independence	0.0431*** (0.015)	0.0266* (0.016)	0.0200 (0.023)
Managerial ownership	−0.0007*** (0.001)	−0.0003 (0.001)	0.0002 (0.001)
Block ownership	−0.0001 (0.001)	0.0001 (0.001)	0.0001 (0.001)
Unitary leadership	−0.0069 (0.006)	−0.0049 (0.007)	−0.0109 (0.009)
Independent nominating	−0.0101 (0.007)	−0.0080 (0.006)	−0.0350*** (0.009)
Delaware incorporation	0.0105* (0.006)	0.0045 (0.006)	0.0092 (0.009)
Poison pill	0.0062 (0.006)	0.0080 (0.007)	0.0025 (0.010)
Leverage	−0.1274*** (0.019)	−0.1019*** (0.024)	0.0598 (0.040)
Company size	0.0065*** (0.002)	0.0053*** (0.002)	0.0049 (0.003)
Operating profitability	−0.3289*** (0.021)	−0.3415*** (0.051)	0.3680*** (0.061)
Intercept	−0.0158 (0.034)	0.0275 (0.046)	0.2084** (0.105)
Adjusted <i>R</i> ²	—	0.410	0.102
Sample size	1,828	769	1,794

Notes: *R&D* is the ratio of R&D expenditure to total assets. The *R&D I* regression is a Tobit regression estimated for all sample companies. The *R&D II* regression is an OLS regression estimated for companies with nonzero R&D expenditures. *DK/K* is net investment in PP&E normalized by net PP&E. Other variables are defined in the notes to Table 1. Financial variables were averaged over 1995–2002, and governance variables were obtained from 1995 proxy statements. Each regression included two-digit SIC code dummies to control for industry factors. Robust standard errors are based on White (1980) to account for potential heteroscedasticity.

*Significant at the 10 percent level.

**Significant at the 5 percent level.

***Significant at the 1 percent level.

possibility that *some* companies benefit from classified boards. I focused on companies with complex and relatively risky operations because such companies are often considered most likely to benefit from electing directors to staggered terms. The rationale is simple: Both institutional and board stability are particularly valuable to companies with complex operations because these companies are exposed to a high degree of uncertainty in their operating environments. For instance, Gerber Scientific asserted in its 2002 proxy statement that a classified board provides stability, which “is particularly important to a company like Gerber where product development requires major investments to be made over long

periods of time.” Similarly, Boeing stated in its 2002 proxy statement that “continuity made possible by the classified board structure is essential to the proper oversight of a company like ours that has high-technology products.” Thus, if classified boards are beneficial, their benefits should be especially pronounced at these companies.

I defined two measures of operational complexity and uncertainty. The first measure was R&D expenditure. I assumed that R&D-intensive companies are more likely than non-R&D-intensive companies to have significant exposure to operational uncertainty because of the high-risk nature of R&D investment. (This notion is alluded

to in the quotes from Boeing and Gerber Scientific.) I classified companies as R&D intensive if their R&D expenditures as a percentage of total assets were greater than the 75th percentile. The second measure of operational complexity and uncertainty focused on certain industries that I believed to be more likely than other industries to involve complex operations. These industries are pharmaceutical and chemical preparations; petroleum extraction and refining; industrial machinery and equipment; semiconductors and related devices; aircraft, guided missiles, space vehicles, and other transportation equipment; instruments and related products; computers and related products; communications; and software development.⁸

I began by examining the impact of classified boards on board stability among these complex companies. As **Table 5** shows, univariate results are similar to those obtained for the full sample provided in Table 2. I also estimated regressions (unreported here) analogous to those in Table 3 to control for other factors that might affect board stability. As with the results reported for the full sample, I found that classified boards did not have any significant impact on board stability among complex companies.

Next, I analyzed the impact of classified boards on long-term investments by complex companies. Again, the results are similar to those for the full

sample. On average, R&D-intensive companies with classified boards invested 8.5 percent of their assets in R&D over the 1995–2002 period. In contrast, R&D-intensive companies with nonclassified boards invested 14.0 percent in R&D over the same period. Similarly, companies with classified boards in complex industries invested an average of 5.0 percent in R&D, compared with an average of 9.3 percent for those with nonclassified boards in the same industries. The difference in each case is statistically significant at the 5 percent level. Furthermore, I obtained similar results (unreported here) when I analyzed investments in *DK/K* and when I estimated regressions similar to those in Table 4 to control for other factors that might affect corporate investment in R&D and long-term physical assets.

Finally, I considered the impact of classified boards on the creation of value for shareholders among complex companies. I reasoned that if classified boards benefit complex companies, those benefits should be reflected in superior shareholder value. Following several recent studies, I measured shareholder value by using Tobin's *q*, which I calculated as the market value of common equity plus the book values of preferred equity and long-term debt divided by the book value of assets.⁹ I found an average Tobin's *q* of 2.03 for R&D-intensive companies with classified boards, compared with

Table 5. Classified Boards and Board Stability among Complex Companies, 1995–2002

Variable	Nonclassified Boards	Classified Boards	<i>t</i> -Statistic
<i>A. R&D-intensive companies</i>			
All directors	59.0%	55.4%	1.490 (0.136)
Affiliated directors	59.0	52.8	1.850* (0.065)
Independent directors	59.3	57.1	0.760 (0.448)
<i>B. Selected industries</i>			
All directors	58.8%	57.8%	0.520 (0.605)
Affiliated directors	58.3	56.3	0.770 (0.439)
Independent directors	58.7	58.1	0.24 (0.809)

Notes: Board stability is the proportion of 1995 directors that remained on the board in 2002. *R&D-intensive companies* are companies with R&D expenditure as a percentage of total assets greater than the 75th percentile. *Selected industries* are a group of industries regarded as complex: pharmaceuticals and chemicals; petroleum extraction and refining; industrial machinery; semiconductors and related devices; aircraft, guided missiles, and space vehicles; instruments and related products; computers and related products; communications; and software development. Other variables are defined in the notes to Table 1.

*Significant at the 10 percent level.

2.47 for R&D-intensive companies with nonclassified boards. The difference is statistically significant at the 1 percent level. Thus, R&D-intensive companies with nonclassified boards created 22 percent more shareholder wealth than those with classified boards. Similarly, I found an average Tobin's q of 1.66 for companies with classified boards in complex industries, compared with 2.10 for companies with nonclassified boards in the same industries. Again, the difference is significant at the 1 percent level.

I estimated regressions of shareholder value on classified boards among these companies. The primary purpose of these regressions was to isolate the effect of classified boards by controlling for other factors that have been shown to affect shareholder value. These variables include the number of directors (Yermack 1996), the percentage of independent directors (Rosenstein and Wyatt 1990), whether the CEO also served as board chair (Rechner and Dalton 1991), managerial ownership (Morck, Shleifer, and Vishny 1988), block ownership (Bethel, Liebeskind, and Opler 1998), independent nominating committee (Callahan, Millar, and Schulman 2003), and investment opportunities (as measured by the ratio of capital expenditures to total assets) and profitability (Yermack 1996). I also controlled for takeover defenses in addition to classified boards (namely, poison pills and Delaware incorporation), company size, leverage, and industry characteristics (all as defined in Table 1).¹⁰ I averaged all variables (other than corporate governance variables) over the 1995–2002 period to ensure only one observation per company in the regressions. Governance variables were obtained from 1995 proxy statements.

As Table 6 shows, I found no evidence that classified boards are advantageous for complex companies, regardless of the measure of complexity. In the estimated regression for R&D-intensive companies, the coefficient on classified boards is -0.1782 . The average Tobin's q among these companies is 2.28. Thus, the coefficient implies that classified boards are associated with a 7.8 percent reduction in company value among R&D-intensive companies. Note, however, that the coefficient is not statistically significant at conventional levels. In contrast, the estimated regression for companies in complex industries indicates that classified boards are associated with an economically and statistically significant reduction in company value as measured by Tobin's q . The average Tobin's q among companies in these industries is 1.90; thus, the -0.3615 coefficient on classified boards implies a 19 percent reduction in company value for companies with classified boards compared with those companies that elected all directors annually.

Table 6. Classified Boards and Company Value among Complex Companies, 1995–2002
(robust standard errors in parentheses)

Characteristic	R&D-Intensive Industries	Selected Industries
Classified board	-0.1782 (0.155)	-0.3615^{***} (0.109)
Board size	-0.0945^{**} (0.045)	-0.0591^{**} (0.029)
Board independence	0.2161 (0.480)	0.1136 (0.315)
Managerial ownership	-0.0153^{***} (0.006)	-0.0128^{***} (0.003)
Block ownership	-0.0178^{***} (0.007)	-0.0092^* (0.005)
Unitary leadership	-0.1905 (0.172)	-0.1873 (0.127)
Average directorships	-0.0303 (0.253)	0.0548 (0.169)
Average director age	-0.0352^* (0.019)	-0.0269^{**} (0.012)
Independent nominating	-0.2450 (0.194)	-0.2733^{**} (0.131)
Delaware incorporation	0.1723 (0.168)	0.1833 (0.117)
Poison pill	-0.1888 (0.202)	-0.0043 (0.137)
CAPEX/assets	3.2811 (2.331)	1.2226 (1.001)
Leverage	-2.4154^{***} (0.671)	-0.2967 (0.975)
Company size	0.1481* (0.079)	0.1074** (0.050)
Operating profitability	-0.6610 (0.852)	-0.4755 (0.741)
Intercept	3.3319*** (1.390)	3.9042*** (0.689)
Adjusted R^2	0.191	0.116
Sample size	458	706

Notes: The dependent variable in each regression is Tobin's q . All variables are defined in notes to Table 1. Financial variables were averaged over 1995–2002, and governance variables were obtained from 1995 proxy statements. The regression in the first column was estimated for companies with R&D expenditure as a percentage of total assets greater than the 75th percentile. The second column is for companies in complex industries as defined in the notes to Table 5. Each regression included two-digit SIC code dummies to control for industry factors. Robust standard errors are based on White (1980) to account for potential heteroscedasticity.

*Significant at the 10 percent level.

**Significant at the 5 percent level.

***Significant at the 1 percent level.

Overall, these results are inconsistent with the argument of classified-board proponents. These results suggest that even among companies subject to a high degree of complexity and operational uncertainty, classified boards do not enhance board stability or long-term strategic risk taking and are associated with a significant reduction in shareholder wealth.

Potential Endogeneity. A plausible concern with my results is the possibility of self-selection because poorly performing managers could select classified boards as a means of avoiding takeover-related discipline. In that case, cross-sectional regressions like the ones reported here will show a negative relationship between classified boards and company value, even though this is simply a result of poor performers choosing to classify their boards.

I addressed this concern in several ways. First, I excluded from my sample those companies that classified their boards after 1990. Thus, each company would have had a classified board for at least five years before the period of my empirical analysis. I based this decision on the logic that several years after a company's adoption of a classified board, performance variation is more plausibly a result of board classification than of the board's being classified in anticipation of poor performance 5–12 years later.¹¹ Using the new sample, I estimated additional regressions similar to those in Table 6. Results (not tabulated here) were quite similar to those reported for the full sample. For example, in the estimated regression for R&D-intensive companies, the coefficient on classified boards is -0.1469 , compared with -0.1782 for the full sample. In addition, in the regression for selected industries, the coefficient on classified boards is -0.4147 (significant at the 1 percent level), compared with -0.3615 for the full sample, as reported in Table 6.

Next, because all classified boards in the restricted sample were adopted by 1990 and Morck, Shleifer, and Vishny (1989) showed that hostile takeovers in this period were often preceded by poor financial performance, I estimated additional (unreported) regressions that controlled for prior performance by using two alternative performance variables (profitability and Tobin's q , both averaged over 1985–1989) to rule out the possibility that my results were mere artifacts of poor prior performance. Once again, I found a negative association between classified boards and company value among complex companies, similar to the results presented in Table 6.

Finally, I analyzed the effect of classified boards on company value among complex compa-

nies that had such boards at their IPO dates. I based this approach on the reasoning that the decision to adopt a classified board is less likely to be endogenous for these companies. I used data from CRSP to determine IPO dates and then estimated regressions for companies with classified boards at the time of their IPOs and companies with nonclassified boards. As before, I found classified boards to be negatively related to company value in these (unreported) regressions.

Overall, these results do not support a self-selection argument. Rather, they are consistent with the notion that classified boards hinder the effectiveness of corporate governance and impede a company's ability to create value for its shareholders, even among companies with relatively complex operations.

Conclusion

In this study, I conducted a broad evaluation of the nontakeover benefits attributed to classified boards by focusing on the effects of classified boards on board stability and corporate investment in company-specific capital assets. I also analyzed the impact of classified boards on value creation among complex companies.

Using hand-collected data covering 1995–2002 for a sample of 2,072 companies, I found no special benefits to having a classified board. The findings suggest that board stability is similar for companies with either classified or nonclassified boards and that continuity rates for independent directors are alike for both categories of companies. Moreover, companies with classified boards invested less than those with nonclassified boards in R&D and other company-specific capital assets, which suggests that electing directors to staggered terms does nothing to cultivate long-term strategic thinking. These results held for companies with relatively complex operations, a group often considered most likely to benefit from classified boards. Classified boards were also negatively associated with value creation among these companies.

These results contradict some of the strongest arguments in support of classified boards. Although supporters often defend classified boards as promoting board stability, director independence, and a culture of effective long-term strategic planning, this study suggests otherwise. Thus, advocating classified boards on the basis of such arguments is problematic. Rather, the current wave of shareholder activism aimed at declassifying corporate boards appears to be well justified.

This article qualifies for 1 CE credit.

Notes

1. On 18 April 1990, Massachusetts enacted legislation establishing staggered elections as the default mode for electing directors to the boards of public companies incorporated in that state. Companies are permitted to opt out of this provision, either by an action of the board or by shareholder approval at an annual meeting.
2. Because directors serving on a classified board are elected to staggered (overlapping) terms, classified boards are sometimes referred to as staggered boards. This article uses the term "classified boards" throughout.
3. See www.governanceanalytics.com/content/menutop/content/subscription/usvmfiles/x741.html.
4. See Jarrell and Poulsen (1987); Mahoney and Mahoney (1993); Faleye (2007); Bebchuk, Coates, and Subramanian (2002).
5. Koppes, Ganske, and Haag (1999, p. 1052), for instance, argued that the "notion that an individual who undertakes a three-year project will tend to have a longer-term focus than an individual who undertakes a one-year project seems commonsensical." Item 7 of the Boeing 2002 Proxy Statement opposed a proposal to declassify the board because the "continuity made possible by the classified board structure is essential to the proper oversight of a company like ours that has high-technology products and programs that require major investments to be made over long periods of time."
6. All results mentioned but not fully tabulated or reported here are available from the author.
7. Faleye (2007), Frakes (2007), and Bebchuk and Cohen (2005) found that classified boards were associated with significantly lower value creation than were nonclassified boards.
8. I also considered other measures of complexity, including company size (larger companies are more complex than smaller companies), growth rate (rapidly growing companies are subject to greater uncertainty), and asset characteristics (companies with less tangible assets are subject to greater uncertainty). Using these measures, I found results (unreported here) similar to those presented in this article.
9. Recent studies that measured shareholder value by using Tobin's q include Callahan, Millar, and Schulman (2003), Bebchuk and Cohen (2005), and Faleye (2007).
10. I attempted to control for the Governance Index (or G Index, constructed as a proxy for the level of shareholder rights) of Gompers, Ishii, and Metrick (2003) but found that more than 40 percent of my sample companies were not included in the Investor Responsibility Research Center database on which the G Index is based. The good news is that my results are based on a sample largely different from the samples of other studies of classified boards (e.g., Bebchuk and Cohen 2005; Frakes 2007). My obtaining results consistent with these other studies suggests that the effects documented for classified boards are not sample dependent. The bad news is that controlling for the G Index results in a significant loss of sample companies and statistical power. I addressed this difficulty in two ways. First, I collected data on state of incorporation and poison pills (two key components of the G Index) for my full sample of complex companies and included these variables as individual controls. The results presented in Table 6 include these two variables. Second, using the G Index as a control variable, I estimated separate regressions for complex companies for which I did have G Index data. I found that classified boards remained negative but became statistically insignificant, most likely because of the loss of statistical power stemming from the reduced sample size. Consistent with the power argument, the G Index is also statistically insignificant in these regressions. These results are available from the author.
11. This approach was also used by Bebchuk and Cohen (2005), Faleye, Mehrotra, and Morck (2006), and Faleye (2007), among others.

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