How Does Private Firm Innovation Affect Anti-Takeover Provisions in Corporate Charters?

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The role of anti-takeover provisions (ATPs) in the corporate charters of firms has recently become a matter of considerable debate in the academic literature. On the one hand, earlier studies have argued that ATPs entrench firm management and therefore depress firm performance by mitigating the disciplining effect of the market for corporate control on firm management (Field and Karpoff (2002)). On the other hand, more recent papers have argued that ATPs in fact improve firm performance post-IPO. Chemmanur, Paeglis, and Simonyan (2011) argue that ATPs allow higher quality top management teams to create long-run value for the firm post-IPO and show that, in the hands of higher quality managers, firms with a larger number of ATPs obtain higher IPO valuations and have better post-IPO operating performance. The role of ATPs in the corporate charters of firms going public has also become controversial among practitioners. While, prior to 1990, firms with dual-class share structures were prohibited from listing on the New York Stock Exchange, many prominent technology firms have gone public within the last decade with dual-class share structures and other strong ATPs in their corporate charters. For example, Google, Facebook, and LinkedIn have gone public with dual-class share structures and currently maintain them. These firms also had other strong ATPs such as staggered boards in their corporate charters at the time of going public (e.g., Facebook and LinkedIn).

The effect of having a larger number of ATPs in a firm’s corporate charter on a specific aspect of corporate performance, namely, corporate innovation, has also been the subject of considerable debate in the literature. For example, Atanassov (2013) uses the enactment of business combination laws as a proxy for the decrease in the threat of hostile takeovers and finds that state anti-takeover laws stifle innovation. However, Chemmanur and Tian (2018), using a variety of empirical methodologies, show that firm-level ATPs spur corporate innovation in seasoned firms. Our paper contributes to the aforementioned debate on the link between ATPs and corporate innovation by analyzing the reverse relationship: how the innovativeness of a firm prior to its IPO affects the number of ATPs in its corporate charter. Since corporate charters are formed only at the time of IPO, we are able to avoid the potential endogeneity problem affecting the existing literature on the relationship between ATPs and firm performance.

We test the implications of two hypotheses with opposing predictions: the “long-term value creation” hypothesis and the “management entrenchment” hypothesis. The long-term value creation hypothesis predicts that more innovative private firms and those with higher top management quality will include a larger number of (and stronger) ATPs in their corporate charters. This is because a larger number of (and stronger) ATPs allow more innovative firms to be insulated to a greater extent from potential takeovers, thus obtaining the time required to bring their long-term (more innovative) projects to fruition.

Further, under the long-term value creation hypothesis, for a given level of innovativeness, firms with higher quality top management teams will have a larger number of ATPs in their corporate charters. In contrast, under the management entrenchment hypothesis, ATPs serve mainly to entrench incumbent firm management and consequently reduce managerial effort and innovation output. Under this hypothesis, more innovative private firms will incorporate a smaller number of (or weaker) ATPs in their corporate charters at the time of their IPOs. Further, assuming that the effort cost of higher quality managers is smaller (so that their benefit from shirking is smaller), then, for a given level of firm innovativeness, the higher the quality of a firm’s top management, the smaller will be the number of ATPs included in its corporate charter under the management entrenchment hypothesis.

Our empirical findings in the first part of the paper show that, first, firms that are more innovative pre-IPO (as measured by either the quantity or the quality of innovation) are likely to have a larger number of ATPs and stronger ATPs in their corporate charters at IPO. Second, the higher the quality of a firm’s top management team, the greater is the number (and the strength) of ATPs in its corporate charter. Third, the joint effect of pre-IPO innovativeness and top management quality on the number and strength of ATPs in a firm’s corporate charter at IPO is also positive. We also find that the above relationships hold for several of the individual (and strongest) firm-level ATPs. In particular, we find that pre-IPO innovativeness and top management quality are positively and significantly related to the prevalence of staggered boards and poison pills, which are likely to greatly reduce takeover probability. These findings provide support for the long-term value creation hypothesis and contradict the management entrenchment hypothesis.
In the second part of our paper, we investigate whether having a larger number of (or stronger) ATPs in a firm’s corporate charter allows the firm to produce more (and higher quality) innovation post-IPO. In particular, we find that, first, firms with stronger ATPs in their corporate charters at the time of IPO have significantly greater innovation productivity in the years immediately post-IPO in terms of the quantity, quality, as well as the economic and scientific significance of the patents produced. Second, the joint effect of strong ATPs in a firm’s corporate charter at IPO and top management quality on post-IPO innovation is also positive. Finally, we find that firms with a combination of high pre-IPO innovativeness and stronger ATPs in their corporate charters are valued higher both at their IPOs and immediately after their IPOs in the secondary market trading compared with the average for all other firms in our sample. Our findings provide further support for the long-term value creation hypothesis and contradict the management entrenchment hypothesis.

Overall, the findings of our empirical analysis suggest that more innovative private firms choose to have a larger number of and stronger ATPs in their corporate charters. They do so to provide insulation for top management from potential takeovers and to lengthen their investment horizons and motivate management to undertake a larger proportion of long-term (innovative) projects without interference from the market for corporate control. Consistent with the long-term value creation hypothesis, this relationship is stronger in firms with higher top management quality. The results from our analysis also suggest that, consistent with their motivation for including a larger number of (and stronger) ATPs in their corporate charters, the above firms are also able to achieve greater innovation productivity (in terms of the quantity, quality, and economic and scientific significance of the patents produced) in the years immediately post-IPO. Our finding that the IPO market rewards firms with a combination of greater pre-IPO innovation productivity and stronger ATPs with greater firm valuations provides further support for the notion that the motivation for firms to include a larger number of (and stronger) ATPs in their corporate charters is indeed to create greater long-run value for shareholders.

This post comes to us from professors Thomas J. Chemmanur at Boston College, Manish Gupta at the University of Nottingham, and Karen Simonyan at Suffolk University. It is based on their recent article, “How Does Private Firm Innovation Affect Anti-Takeover Provisions in Corporate Charters? Evidence from Firms Going Public,” available here.