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ScienceDirect
Journal of Corporate Finance 13 (2007) 485 – 510
Journal of CORPORATE FINANCE
www.elsevier.com/locate/jcorpfin

When managers bypass shareholder approval of board appointments: Evidence from the private security market ☆

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Available online 15 May 2007

Abstract

This paper investigates the influence of managerial entrenchment on private placements by examining the firm's decision to appoint representatives of the private investors to the board without shareholder approval. By analyzing a sample of U.S. firms that appoint directors in combination with private offerings between 1995 and 2000, we find that firms with greater managerial entrenchment are more likely to bypass shareholder approval. Firms that bypass shareholders are less likely to appoint independent directors or to elect one of these directors as chairman. We also show that the market reacts more positively to the private offering announcement when the firm submits its board candidates for shareholder approval. Further, firms that bypass approval underperform compared to firms that obtain it. Overall our findings suggest that managers avoid shareholder approval to perpetuate entrenchment.

JEL classification: G32; G34; K22
Keywords: Shareholder voting rights; Board of directors; Private placement

☆ We wish to thank Royce Barondes, Paul Brockman, Mark Frigo, Clifford Holderness, John Howe, Tim Loughran, Michael McCracken, Hamid Mehran, Kenneth Scott, Tina Yang, an anonymous referee, and seminar participants at the University of Missouri—Columbia, the 2005 European meeting of the FMA, the 2005 FMA annual meeting, and the *Journal of Corporate Finance* Special Issue Conference on "Private Equity, Leveraged Buyouts, and Corporate Governance" for helpful comments and suggestions. We also wish to thank Qi (Carol) Wang for her research assistance. While at University of Missouri, Arena received support from the Alan C. Greenberg Summer Research Fellowship and the Ponder Scholarship Fund.
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doi:10.1016/j.jcorpfin.2007.04.001

1. Introduction

The conventional view of private equity placements as a mechanism to enhance external monitoring has been recently challenged by studies arguing that managers can use private placements to promote their own entrenchment (i.e., Wu (2004) and Barclay et al. (2007-this issue)). In this paper we contribute to the debate over the governance implications of private placements by analyzing a heretofore unexamined aspect of that process. Specifically, we examine the decision to appoint representatives of private investors to the firm's board of directors without a vote of the shareholders.

Wruck (1989) finds that private placements in which investors are appointed to the board are characterized by significantly lower announcement period returns. She conjectures that the appointment of these individuals without shareholder approval might be the cause of the lower returns. This study tests her conjecture and provides an estimate of value of shareholder participation in the selection of a firm's board of directors. Such analysis has important implications for corporate governance, especially in environments where super-voting rights might exist or external equity investors are otherwise disadvantaged.

Our analysis of the circumvention of shareholder approval for the appointment of directors also contributes to a continuing policy debate regarding the extent of shareholder power in the director election process and the role of independent directors. Even though a 2003 SEC proposal on this issue stalled due to the opposition of senior industry executives, by early 2006 some firms have implemented changes in their bylaws to increase shareholder power during the director election process. These changes are consistent with the position advocated by activist shareholders and various legal academics.[2] Further, since this research examines the effects resulting from the nullification of a basic shareholder right, it benchmarks the impact that violation of one share-one vote rules might have on firms in countries with weak protection of shareholder interests.

Wruck (1989) suggests that the appointment of directors without shareholder approval at the time of a private offering might imply managerial entrenchment. According to this view, managers bypass shareholders and appoint to the board individuals who are aligned with current management and unlikely to provide independent monitoring. Such directors are likely to be less effective monitors than those who are regularly elected by shareholders. Barclay et al. (2007-this issue) and Wu (2004) argue that firms are more likely to privately place securities with investors who promise to vote their shares in managers' favor and consequently protect managers' positions. If true, this is more likely to occur when firms assign directorships to representatives of these private investors. As long as entrenched managers estimate the probability that shareholders will oppose their slate of board candidates to be greater than zero, they will more likely circumvent the shareholder election process to appoint "friendly" investors to the board.[3] We call this the *entrenchment hypothesis*.

Berle and Means (1932) and more recently Demb and Neubauer (1992) and Lorsch (1989), question the importance of shareholder voting for directors since the firm's proxy committee is appointed by the existing management and the proxy slate is usually elected, resulting in

[2] See for example "Stock Activism's Latest Weapon" By Mark Maremont and Erin White, *Wall Street Journal*, April 4, 2006.

[3] If shareholders are not satisfied by the management's slate they can propose their own candidates. Excluding contests related to M&A activity, Bebchuk (2003) reports that there were 77 contested director proxies between 1996 and 2002. Therefore it is plausible that managers expect the probability of shareholders rejecting management slate to be greater than zero.