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Do Delaware CEOs get fired?☆

Murali Jagannathan[a], A.C. Pritchard[b,*]

[a] Binghamton University, AA210, School of Management, Binghamton, NY 13902, US
[b] University of Michigan Law School, 1039 Legal Research, Ann Arbor, Michigan 48109, US

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ABSTRACT

Critics have charged that state competition in corporate law, which Delaware dominates, leads to a "race to the bottom" making management unaccountable. We argue that Delaware corporate law attracts firms with particular financial and governance characteristics. We find that Delaware attracts growth firms in industries with more takeover activity. Delaware firms have smaller boards, and their directors are paid more and serve on more boards. In addition, Delaware firms attract greater institutional ownership. We also provide a bottom-line test of the race-to-the-bottom hypothesis by examining forced CEO turnover. After controlling for differences in firm characteristics, we find that firms incorporated in Delaware are more likely to terminate CEOs. We also find that that termination decision is less sensitive to poor performance. Overall, we see no clear pattern supporting the "race to the bottom" hypothesis.

1. Introduction

In this paper, we examine the relation between state corporate law and corporate governance. State corporate law determines most questions of internal corporate governance, such as the role of boards of directors and the allocation of authority between directors, managers and shareholders. Companies have discretion in choosing their state of incorporation. The allocation to the states of primary authority over corporate governance, when combined with the "internal affairs" doctrine, which holds that courts must apply the law of the state of incorporation to corporate law disputes, has created a regime of "issuer choice" in state corporate law. Issuer choice allows corporations to choose their preferred state corporate law without regard to where the corporation is headquartered or principally does business.

Issuer choice implies that states can compete to attract firms by offering the most attractive corporate law regime. Delaware has clearly prevailed in the competition for corporate charters. That state draws a clear majority of the nation's largest public companies to incorporate under its corporate code, despite its relatively small population and share of the national economy. In 2014, nearly 89% of companies doing initial public offerings (IPOs) in the United States were incorporated in Delaware.[1] Subramanian (2002) suggests that the competition for corporate charters is largely bilateral: states compete with Delaware in an effort to retain corporate charters. This competition for corporate charters is not just about state pride: Winning the competition for incorporations yields tangible benefits: Charter fees made up more than a quarter of Delaware's tax revenues in 2014.[2]

Critics of issuer choice argue that Delaware competes for corporate charters by pandering to management. Delaware has won this competition, they claim, by leaving shareholders vulnerable to overreaching by corporate managers, who dominate the incorporation decision. Most famously, William Cary (1974), a former SEC chairman, charged that states were caught in a "race to the bottom," providing rules that undermine management accountability to shareholders.

To test this hypothesis, we first develop a model of incorporation choice. We argue–and document–that Delaware lures firms in-

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* Corresponding author.
E-mail addresses: MuraliJ@binghamton.edu (M. Jagannathan), acplaw@umich.edu (A.C. Pritchard).

[1] Delaware Division of Corporations, 2014 Annual Report, at 1, available at http://corp.delaware.gov/newsroom.shtml.

[2] Delaware Division of Corporations, 2014 Annual Report, at 2 (reporting that division collected $927.8 million dollars in fiscal year 2014 and accounted for 26% of the state's general fund).

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tent on growth, which has important implications for governance. Growth firms face a greater risk of securities fraud class actions and are also more likely be involved in mergers, which may also attract lawsuits. Consequently, directors of growing firms may prefer Delaware's predictable courts and surer protection against personal liability. The downside of liability protections, however, is that they may reduce the incentive of directors to monitor management. Cary (p. 686) notes in particular Delaware's director-friendly standard regarding the duty of care and indemnification. Since Cary wrote his famous article, Delaware's duty of care standard has only been further diluted.

We document that the corporate governance of Delaware firms, including pay and service on multiple boards, differ from that of non-Delaware firms. Consistent with Delaware directors being in higher demand, we find that they are paid more and hold more directorships. They also have a shorter tenure than directors of non-Delaware firms. Delaware firms also have higher institutional and block ownership than other firms, which does not suggest weaker monitoring in these firms. We find that the governance of Delaware firms continue to be significantly different from that of propensity score matched non-Delaware firms, although there is no clear pattern suggesting that it is weaker.

Having shown that Delaware firms differ in their financial and governance characteristics, we examine the relation between Delaware incorporation and the likelihood of forced CEO turnover. Cary and other race-to-the-bottom adherents argue that Delaware encourages lax monitoring, which suggest that Delaware boards will be less likely to fire CEOs. Overall, we find that Delaware incorporation is associated with higher rates of forced turnover. This relation holds when Delaware firms are compared to propensity score matched control firms. We also find that Delaware firms are more likely to force out CEOs even without obvious poor performance. Overall, our results do not support the argument that Delaware CEOs are more entrenched than other CEOs.

We proceed as follows. Section 2 compares Delaware's corporate law with that of other states and explores how those differences may appeal to firms with particular financial characteristics. Section 3 explores the relation between the choice of incorporation and firms' financial and governance characteristics. Section 4 presents our analysis of forced CEO turnover. We conclude with a discussion of our results in Section 5.

2. State of incorporation and firm characteristics

Does Delaware corporate law differ in a way that is likely to appeal to firms with particular financial characteristics? We argue that growth firms may prefer Delaware law because it facilitates mergers and offers directors sure protections against liability, which may be relevant to the monitoring provided by Delaware directors. There is some evidence in the prior literature to support the argument that Delaware attracts growth firms. Daines (2001), for example, finds that Delaware firms have a higher Tobin's *Q*. His finding is consistent with Heron and Lewellen (1998), who find that reincorporating firms (primarily to Delaware) have higher market-to-book ratios, invest more in R&D, and are larger, relative to firms incorporated in other jurisdictions.

2.1. Facilitating acquisitions & discouraging takeovers

One source of Delaware's comparative advantage may relate to facilitating corporate combinations. Romano (1985) finds that firms are likely to reincorporate in Delaware before committing to a program of mergers and acquisitions. Delaware, with its doctrine of "independent legal significance," gives corporations flexibility in structuring transactions. This doctrine takes on practical importance in allowing acquiring corporations to avoid shareholder votes and appraisal rights in most circumstances. Celikyurt et al. (2010) show that newly public firms make acquisitions at a very rapid pace, so Delaware's voting rules may be attractive for companies choosing their incorporation status at the IPO stage (the typical time for reincorporation), particularly if they anticipate rapid growth after going public. On the flip side, Daines (2001) presents evidence that firms are also more likely to be acquired if they are incorporated in Delaware. By contrast, more stable firms that plan to continue with an existing business plan rather than growing through combination would garner less benefit from reincorporating in Delaware and therefore would see less reason to pay the additional expense of Delaware incorporation.

Consistent with firms having a stable business plan eschewing Delaware, both Subramanian (2002) and Bebchuk and Cohen (2003) find that states that have adopted anti-takeover statutes have more success in retaining the incorporations of firms headquartered there. It is possible that insulation from hostile takeover may also insulate boards from shareholder pressure relating to the firm's underperformance. Kahan (2006), however, after controlling for other factors that might influence choice of incorporation–in particular liability protections (discussed below)–finds no evidence that firms are likely to incorporate in states with anti-takeover statutes. Moreover, hostile takeovers have faded from significance during our sample period (Hartzell etal., 2004). In any event, Delaware's corporate code has adopted an intermediate position with respect to anti-takeover provisions, so firms bent on discouraging takeovers would be better insulated in states with more draconian legislative countermeasures, such as Georgia, Ohio, Pennsylvania, Maryland, and Virginia.[3] In Delaware, the validity of the poison pill is firmly established,[4] although there are limits on the type of pill that can be adopted; Delaware courts have held invalid dead hand and no hand pills.[5] Thus, Delaware firms are not defenseless, but it is clearly not leading a race to the bottom in antitakeover protections.

2.2. Liability protection

Delaware may appeal to firms that anticipate greater exposure to shareholder lawsuits by offering liability protection to officers and directors. Moodie (2004) documents that Delaware reincorporations surge after Delaware adopts liability protections for directors. When the Delaware Supreme Court did the unthinkable in *Smith v. Van Gorkom*[6] — holding TransUnion's directors personally liable in connection with the company's acquisition — the Delaware legislature quickly restored equilibrium by allowing corporations to eliminate money damages for duty of care violations in their charters (Del. Gen. Corp. L. § 102(b)(7)). The Delaware legislature's swift response actually accelerated reincorporations to Delaware (Moodie, 2004), particularly from California (Netter and Poulson, 1989). The lawyers who advise officers and directors are also likely to find liability concerns salient, and lawyers are the most common instigators of reincorporation decisions (Romano, 1985; Daines, 2001).

[3] Pennsylvania, Georgia, and Virginia appear to authorize "dead hand" or "slow hand" pills, which may be the functional equivalent of a staggered board. AMP Inc. v. Allied Signal Inc., 19987 U.S. Dist. Lexis 15617 (upholding slow hand pill under Pennsylvania law); Ga. Code Ann. § 14-2-624(d); Va. Code Ann. § 13.1-646. Ohio and Pennsylvania have statutes that force disgorgement of short-term gains by hostile bidders (Ohio Rev. Code Ann. §1707.043; 15 Pa. Cons. Stat. §§2571-2575.); Massachusetts imposes classified boards on companies by statute (Mass. Gen. Laws Ann. Ch. 156B, § 50A) and Maryland allows boards to adopt an effective classified board structure without shareholder authorization (Md. Code Ann., Corps. & Ass'ns §3-803).

[4] Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).

[5] Quickturn Design Sys., Inc. v. Mentor Graphics Corp., 721 A.2d 1281 (Del. 1998).

[6] 485 A.2d 858 (Del. Sup. Ct. 1985).