

# Implications Of CEO Structural And Ownership Powers, Board Ownership And Composition On The Market's Reaction To Antitakeover Charter Amendments

Ali R. Malekzadeh, (E-mail: icarm@asuvm.inre.asu.edu), Arizona State University West  
Victoria B. McWilliams, (E-mail: icvbm@asuvm.inre.asu.edu), Arizona State University West  
Nilanjan Sen, (E-mail: idnxs@asuvm.inre.asu.edu), Arizona State University West

## Abstract

*This study analyzes how the CEO's structural and ownership powers, along with the board of directors' ownership and composition influence the market's reaction to antitakeover charter amendments. We find conditional support for both the agency and stewardship theories, each being relevant depending on governance mechanisms. The market evaluates the potential effect of the amendments on the balance of power between the CEO and the board of directors, and whether there are any countervailing forces to assure shareholder's rights are being protected.*

## Introduction

The power of the CEO to influence the board's decisions and shape the strategy of the organization is one of the most salient issues in corporate governance. Since Berle and Means (1932) treatise on the separation of ownership and management, the interaction between the board and the CEO has been of much interest to researchers and the public. Although, the CEO's ability to nominate the directors, to set the agenda for the board, to become the chair of the board, and to control the amount and the type of strategic information the directors receive varies from one organization to another, the CEO's formal and informal power

is undeniable. Organizational researchers and practitioners in finance, economics, and strategic management have shown much interest in defining the power of the CEO relative to that of the board of directors (see Finkelstein, 1992; Walsh and Seward, 1990). The balance of power between the CEO and the directors determines to what extent the board of directors can monitor and moderate the activities of the management. The advent of antitakeover charter amendments may significantly affect this balance of power and the subsequent use of the amendments. These amendments can be used to benefit shareholders or to enhance managerial entrenchment that will be detrimental to shareholders (DeAngelo and Rice, 1983; Linn and McConnell, 1983; Mahoney and Mahoney, 1993; Sundara-

*Readers with comments or questions are encouraged to contact the authors via e-mail.*

murthy, 1993). The CEO's impact on how the amendments are used may be a function of whether the CEO is also the firm's chair of the board and/or the board's composition.

Our research focuses on the CEO's power vis-à-vis the monitoring power of the board of directors. We study how the CEO's structural and ownership powers, and the board of directors' share ownership and composition influence the market's reaction to antitakeover charter amendments. When managers propose these amendments for shareholders' approval, the market reacts to the potential impact these devices may have on the balance of power between the board and the CEO, which ultimately may affect how the amendments are used. The combination of these variables in shaping the market's reaction to the amendments have not been studied before.

Our results indicate that the market reacts increasingly negatively to amendment announcements when either the CEO or the board share ownership increases, which supports the agency theory arguments presented below. We also find conditional support for the stewardship theory. Results indicate that, if the market perceives that the structural power of the CEO is balanced by increasing the percentage of outside directors on the board, then the market's reaction to the amendments becomes increasingly positive.

## **Review of Literature and Hypotheses**

### *Antitakeover Charter Amendments*

Antitakeover charter amendments are part of a broader arsenal of takeover defenses. A number of takeover defenses have been used by corporations (for a review see Mahoney and Mahoney, 1993). They range from those that do not require shareholder approval, notably poison-pills (Malatesta and Walkling, 1988; Mallette, 1991; Mallette and Fowler, 1992; Ryngaert, 1988) and golden parachutes (Buchholtz and Ribbens, 1994; Knoeber, 1986; Lambert and Larker, 1985; Singh and Harianto, 1989a,

1989b), to those which require shareholder approval and are thus "charter amendments," such as staggered board, supermajority vote, and fair price charter amendments (DeAngelo and Rice, 1983; Jarrell and Poulsen, 1987; Linn and McConnell, 1983; Mahoney and Mahoney, 1993; Mallette, 1991; McWilliams, 1990; Sundaramurthy, 1993).

While studies exist which examine the stock price reaction to amendment announcement (for a summary see McWilliams, 1992), the sign and statistical significance of results varies. Our intention is to provide insight into the role of corporate governance mechanism, in particular the CEO's structural and ownership powers and board ownership and composition in shaping the market's reactions to antitakeover amendments. Based on earlier research (e.g., Malekzadeh and McWilliams, 1995), such reactions are, to some extent, due to the change in the balance of power between the management and the board of directors, as agent of shareholders.

**Amendments within Agency or Stewardship Theory.** Agency theory predicts that managers adopt antitakeover amendments to reduce the monitoring power of the board and thus to entrench themselves (e.g., Jensen, 1986; Mahoney and Mahoney, 1993). On the other hand, Stewardship theory predicts that managers are in fact acting in the best interest of shareholders when they propose these amendments (e.g., Donaldson, 1990; Donaldson and Davis, 1991). There is much controversy about both positions. If one believes that all managers are fundamentally greedy and care primarily about their own careers, then agency theory holds. On the other hand, if one believes that managers are fundamentally honest and care primarily about the interest of shareholders, then stewardship theory holds (for a discussion, see Boyd, 1995; Finkelstein and D'Aveni, 1994; Walsh and Kosnik, 1993). Walsh and Kosnik (1993) state that all parties have a certain degree of self-interest in the takeover game. Finkelstein and D'Aveni (1994) also state that the circumstances under which each theory applies need to be considered. We intend to shed some light on how the market

perceives the degree of self interest of managers and the monitoring role of board members when they propose antitakeover amendments. Depending on the market's perception of relative power of the CEO and the board, the announcement of these amendments can lead to either a positive or a negative reaction. Based on previous studies, we operationalize the relative power of the CEO and the board by studying the CEO's structural and ownership powers, and the board's ownership and composition.

#### *Dimensions of CEO and Top Management Team Power*

Finkelstein (1992) proposes four types of power for the CEO and the Top Management Team (TMT). The first two, structural power, and ownership power, are germane to our study.

**Structural power.** This type of power is based on the formal titles held by the top managers. For example, a CEO is seen as having more power if s/he also holds the title of the chair of the board. Boyd (1995) states that combining the titles of CEO and chair of the board is an important structural signal for the public about the power of the CEO. In addition, Finkelstein and D'Aveni (1994) conclude that boards of directors carefully evaluate the relative merit of combining the two titles against the possibility of management entrenchment. Empirical evidence is mixed about the desirability of having a CEO/Chair (Boyd, 1995; Daily, 1994; Daily and Dalton, 1992; Dalton and Kesner, 1987; Kesner and Johnson, 1990; Mallette and Fowler, 1993; Rechner and Dalton, 1989, 1991). However, the trend among large U.S. corporations is towards having an independent chair of the board (Daily and Dalton, 1995). Our study focuses on CEO's structural power as an important variable affecting the market's reactions to the amendment announcements.

**Ownership power.** Ownership power is based on the shares top managers hold: the more the percent of shares owned, the more their power (Finkelstein, 1992). Previous studies have demonstrated that share ownership of the

top executive affects the stock price reaction to the amendments (e.g., Buchholtz and Ribbens, 1994; McWilliams, 1990; Sundaramurthy, 1993). Jensen (1993) recently advocated that CEOs should receive a substantial amount of shares in their firms so that they would act more as owners and less as detached managers. He defined substantial as enough ownership to materially affect their personal wealth. Mahoney and Mahoney (1993) state that such ownership is one of many market mechanisms that can reduce the agency problem of separation of ownership and management. Rediker and Seth (1995) found that managerial share ownership does not necessarily entrench the CEO; other monitoring mechanisms interact with it to enhance or reduce managerial power. In contrast, Stulz (1988) concludes that depending on the level of managerial control of voting rights, firm value may increase or decrease as managers increase their share ownership. We hypothesize below that increasing ownership by the CEO, particularly in the presence of structural power, neutralizes the board's monitoring function and increases the likelihood of amendments contributing to managerial entrenchment.

#### *Board Ownership and Composition*

Besides the ownership and the structural powers of the CEO, the balance of power between the management and the board depends to a large extent on the board members' ownership stake and the composition of the board of directors. Since most boards include a number of TMT members, how much of a stake these insiders have and their resulting voting block relate directly to how well the board can monitor the activities of the CEO and TMT (Buchholtz and Ribbens, 1994; Brickley and James, 1987; Hambrick and Finkelstein, 1995; Kosnik, 1987; Mallette and Fowler, 1992; Sundaramurthy, 1993).

**Board ownership.** As the ownership stake of the director increases, their personal interests are further aligned with those of the shareholders (Fama and Jensen, 1983). Additionally, the concentration of ownership in the hands of one

or a few directors, mitigates the potential agency conflict (Mahoney and Mahoney, 1993), and leads to more vigilance in monitoring the actions of the management (Buchholtz and Ribbens, 1994; Finkelstein and D'Aveni, 1994; Hambrick and Finkelstein, 1995). On the other hand, if the CEO has structural power over the board by being its chair, the market may perceive the increasing ownership stake of the board as collusion with management for entrenchment when antitakeover amendments are proposed. We hypothesize below that the effect of board ownership on the market's reactions to the amendments is conditioned by the CEO's structural power.

**Board composition.** To reduce the potential of a conflict of interest, many experts advocate a board consisting of a majority of outsiders (for discussion see Boyd, 1995; Lorsch, 1989; Mizruchi, 1983; Pearce and Zahra, 1991). However, empirical evidence is inconsistent (for discussions see Baysinger and Butler, 1985b; Baysinger and Hoskisson, 1990; Brickley, Coles and Terry, 1994; Buchholtz and Ribbens, 1994; Friedman and Singh, 1989; Kosnik, 1987; Singh and Harianto, 1989b). For example, while Kosnik (1987) found boards of directors with outsider-majority to resist paying greenmail, Buchholtz and Ribbens (1994) and Singh and Harianto (1989b) found that such boards were more likely to adopt golden parachutes. Furthermore, Mallette and Fowler (1992) found no relation between the proportion of outside directors and the adoption of poison pills, and Baysinger and Hoskisson (1990) state that outside directors may be too busy to provide adequate attention to the issues presented to the board.

The key issue in this debate seems to be the whether the board has the power to oppose the CEO. This power can come from having an outside member of the board serving as chair (Kosnik, 1987; Mallette and Fowler, 1992; Rechner and Dalton, 1991), and/or from reducing the number of TMT members on the board to a clear minority in order to allow the "independent" board to veto management's proposals if necessary (Kosnik, 1987; Fredrickson, Hambrick, and

Baumrin, 1988; Schellenger, Wood, and Tashakori, 1989; Walsh and Seward, 1990). We hypothesize below that amendments are likely to be used as bargaining mechanisms during takeover bids in the presence of outside board members.

**Hypothesis 1:** When the CEO is also the board chair, the amendment announcement stock price reaction will be negatively related to both the level of the board member's share ownership and to the level of the CEO's share ownership.

**Hypothesis 2:** When the CEO is also the chair of the board, as the proportion of outside directors (those unaffiliated with management) increases, the amendment announcement stock price reaction will become increasingly positive.

## Data and Methodology

### Data

We identify 213 firms that propose antitakeover amendments during the period 1980 through 1987 for which data are available. The focus of this study is to explain how the market reaction to antitakeover amendments is conditioned by governance and ownership structure. We argue that increased ownership by the CEO and board members in the presence of having a CEO who is also chair of the board increases the likelihood that the firm will use the amendments as entrenchment-enhancing devices. This coupled with market efficiency suggests a negative relation between the market reaction at amendment announcement and CEO and board share ownership when the CEO is also board chair. In contrast, the proportion of outside directors on the board increases the likelihood that the amendments will be used as bargaining devices in future takeover bids, which suggests a positive impact on the stock price reaction. However, the cross-sectional variation in the reactions is conditional on the information content of the amendment announcements. This necessitates that we focus on a period where other takeover defenses are less prevalent. Comment and Schwert (1995) demonstrate that, after 1987, more than 80% of listed firms were covered by busi-

ness combination statutes, control share law, and poison pills (see Comment and Schwert Fig. 1, p.5). Therefore, the announcement of the amendments at the firm level beyond 1987 did not alter the balance of control. This does not suggest that the monitoring role of the board and impact of ownership/leadership structure cease to be relevant beyond 1987. It is merely the case that it will be harder to capture these effects empirically using antitakeover amendment market reactions since such devices do not reflect any additional information. As such we end the sample period in 1987.

This study focuses on three types of amendments: fair price, staggered board, and supermajority vote amendments. We chose these amendments as opposed to other types of anti-takeover amendments because their unambiguous function is to act as a takeover defense. Other types of amendments may be used for purposes other than defending against takeover. For example, the authorized issuance of common/preferred stock may be used in the event of a hostile takeover to establish a poison pill rights offering and, therefore, is categorized as an anti-takeover amendment. However, the authorization may instead be used as a source of new financing for positive NPV projects, which has nothing to do with fighting an unwanted takeover attempt. Therefore, based on our decision to end the sample in 1987 and to focus on three types of amendments, we construct the sample from two primary sources. We begin by identifying relevant firms (i.e., those that propose fair price, staggered board, supermajority vote amendments) from McWilliams (1990).

To determine board composition, we use a three-way classification technique described in Byrd and Hickman (1992) and developed by Baysinger and Butler (1985). We use information contained in the sample firm's proxy statement the year of amendment proposal to identify inside directors, outside affiliated directors, and independent outside directors. We identify as inside directors those individuals who are current officers of the firm (i.e., current employees) or former employees who are currently retired. We

classify a director as outside affiliated when that individual either is or was associated with the firm in some capacity (e.g., firm's legal council, commercial banker, investment banker), but is not an employee of the firm. We identify independent outside directors as those individuals who have no affiliation, past or present, with the firm other than their position on the firm's board of directors (e.g., private investors, executives from other firms with no business dealings with the sample firm). In addition to the information described above, we collected several other variables for this study from the sample firms' proxy statements. Specifically, we identify board and managerial shareholdings, institutional shareholdings, as well as CEO and board chair share ownership from the statements. Table 1 provides the descriptive statistics for our sample.

### *Methodology*

We use regression analysis to determine whether the stock price reaction to the amendments is related to firm power structure and various measures of board and managerial share ownership. To measure the stock price reaction, event study methodology as described by Brown and Warner (1985) is used, and daily common stock returns and market returns are taken from the CRSP files. We measure the stock price reaction to amendment proposals as excess returns relative to expected returns during the announcement period interval using the market model of security returns with value-weighted average returns as the market index. The announcement period interval consists of the proxy statement date and the subsequent trading day. The estimate of expected returns comes from our estimate of the market model. Since 250 return observations approximate the number of trading days in a year, we estimate the parameters of the market model over a 250 day control period (i.e., unaffected by the event) from day -265 to day -16, with the event occurring on day 0, the proxy statement date.

### **Results**

Table 2 presents results for tests of Hy-

**Table 1**  
*Sample Descriptive Statistics*

Variable	Mean	Median	S.D.
A. Share ownership			
Board Share Ownership	9.23%	3.84%	12.01%
Chair of the Board			
Share Ownership	2.94%	0.62%	6.06%
CEO Share Ownership	2.58%	0.54%	5.43%
B. Board composition			
Percent of Inside			
Directors	31%	29%	16%
Percent of Affiliated			
Directors	13%	10%	13%
Percent of Independent			
Directors	56%	60%	19%

hypotheses 1. Results are consistent with the hypothesis. For all firms and for firms where the CEO is also the board chair, the CEO share ownership coefficient estimates are significantly negative.<sup>1</sup> However, for firms where the CEO is not the chair of the board, the share ownership coefficient is not significant for CEO share ownership, and is only marginally significant at the 0.10 level for the chair of the board's share ownership. In addition, the stock price reaction to antitakeover amendment proposals is significantly negatively related to board share ownership when the CEO is also the board chair.<sup>2</sup> While the relation is negative for firms with a non-CEO board chair, it is not statistically significant.

Table 3 presents results for tests of Hypothesis 2. Again, results are consistent with the hypothesized effect. While the intercept coefficient estimate is negative regardless of whether the CEO is or is not the board chair, it is significant, albeit marginally, only when the CEO is the board chair. In addition, the coefficient estimate of the board composition variable is significantly positive only for firms with a CEO who is also the chair of the board.

Our collective results suggest that the market requires a balance of power between the CEO and the board, as agent of shareholders. Antitakeover amendments have the potential to

**Table 2**  
Regression Analysis of the Stock Price Reaction to Antitakeover Amendment Proposals vs. Share Ownership

	All Firms: CEO Share Ownership	All Firms: Chair of the Board Share Ownership	CEO is Chair: CEO Share Ownership	CEO is not Chair: CEO Share Ownership	CEO is not Chair: Chair of the Board Share Ownership	CEO is Chair: Board Share Ownership	CEO is not Chair: Board Share Ownership
Intercept	0.0016	0.0022	0.0035	-0.0040	-0.0017	0.0061	-0.0014
(t-statistic)	(0.67)	(0.93)	(1.18)	(-1.15)	(-0.57)	(1.85)†	(-0.37)
Coefficient	-0.0008	-0.0009	-0.0009	-0.0002	-0.0008	-0.0006	-0.0003
(t-statistic)	(-2.10)*	(-2.65)*	(-2.10)*	(-0.15)	(-1.66)†	(-2.74)**	(-1.07)
N	213	213	157	56	56	157	56
F statistic	4.43*	7.00**	4.40*	0.02	2.77†	7.48**	1.15
R <sup>2</sup>	0.021	0.032	0.028	0.001	0.049	0.045	0.021
†p	0.10; *p	0.05; **p	0.01				

**Table 3**  
**Regression Analysis of the Stock Price Reaction to Antitakeover Amendment Proposals vs. Percentage of Independent Outside Directors**

	CEO is Chair	CEO not Chair
Intercept	-0.0148	-0.0079
(t-statistic)	(-1.75)†	(-0.87)
Coefficient	0.0278	0.0064
(t-statistic)	(1.96)*	(0.42)
N	157	56
F statistic	3.85*	0.18
R <sup>2</sup>	0.024	0.003

†p 0.10; \*p 0.05

change that balance of power, thus, the shareholders react to amendment proposals depending on the leadership and ownership structure of the firm. Finkelstein (1992) refers to this balance of power within the top management team and suggests that researchers examine the distribution of power within the upper echelon. Our findings support his position. Structural power of the CEOs as well as their ownership power need to be balanced against the ownership stake and the composition of the board, to create a more complete picture of the relative power of the CEO and the board when antitakeover amendments are proposed.

We find conditional support for Mahoney and Mahoney’s (1993) and Sundaramurthy’s (1993) findings that amendments can be detrimental to shareholders. In the case where the CEO is also the chair of the board, the market reacts increasingly negatively to amendment announcement when either the CEO or the board share ownership increases. Our results for Hypotheses 1 and 2 provide such evidence, and thus support the agency theory.

We also found conditional support for the stewardship theory. If the market perceives that the structural power of the CEO is balanced by increasing the percentage of outside directors, then its reaction becomes increasingly positive, as shown by our Hypothesis 2 results. In other words, shareholders’ wealth increases when the antitakeover amendments are proposed, because the market perceives the balance of power be-

tween the CEO and the board being maintained even after the adoption of these amendments. This perception leads to the market expectation that the amendments, when power is balanced, will be used in such a way as to be beneficial to shareholders (e.g., increase the bargaining power of management during a takeover attempt).


Finkelstein and D’Aveni (1994) found that in the case of the CEO also being the chair of the board, if the firm is performing well, the board’s attention is directed towards avoiding entrenchment. While we did not specifically address the performance track of our firms, our results enhance Finkelstein and D’Aveni’s (1994) position by showing that, since the CEOs’ structural and ownership powers enhance their overall power when they propose amendments, the presence of outside directors is perceived by the market to monitor against managerial entrenchment.

**Conclusion**

Overall, our research supports Boyd (1995), Finkelstein and D’Aveni (1994), and Walsh and Kosnik’s (1993) findings that agency and stewardship theories may each be relevant depending on the contingencies of governance mechanisms. The picture that emerges is multidimensional. When antitakeover amendments are proposed, the balance of power between the management and the board is significantly affected. The market thus evaluates the potential effect of the amendments on the governance mechanism existing within the firm, and whether there are any countervailing forces to assure shareholder’s rights are being protected. It is the interaction among the CEO’s structural and ownership powers, and the board’s ownership and composition that shapes the market’s expectation about potential use of antitakeover amendments.

**Suggestions for Future Research**

Potential issues for future research include (1) determining whether the CEO’s structural and ownership powers, along with the firm’s board composition, affect long-run performance

once the amendments are in place; and (2) whether the relations found in this study between the stock price reaction to amendments and the variables are the same for different types of amendments. Examination of these research topics will provide additional information about whether the amendments provide long-run benefits, and whether one type of amendment is viewed as particularly harmful or beneficial in light of the CEO's power and the board's composition. 

### Endnotes

1. We included institutional shareholdings, a variable to control for firms' size, and indicator variables to control for industry. In all cases, no coefficient estimates for the control variables were significantly different from zero, and our results reported in Table 2 and Table 3 were unchanged. Therefore, we do not report the results for the control variables; these results are available from the authors.
2. When we regress the stock price reaction to antitakeover amendment proposals vs. board shareholdings for the full sample, we find a significantly negative coefficient estimate. The results for the full sample board shareholdings and the full sample CEO shareholdings are consistent with earlier studies (e.g., Jarrell and Poulsen, 1987; and McWilliams, 1990).

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