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ABSTRACT

Heron, Randall Allen Ph.D., Purdue University, December 1995. An Analysis of the Reincorporation Decision: The Evidence Since 1980. Major Professor: Wilbur G. Lewellen.

This thesis examines the decision made by managers of publicly traded corporations to change the firm's state of incorporation. Due to significant differences in state corporation laws, this action, referred to as 'reincorporation,' can materially alter the contractual relationships governing the firm. The apparent state competition in the market for corporate charters has led to competing viewpoints regarding why managers decide to reincorporate and how the resulting recontracting affects shareholders. On one hand, financial researchers contend that reincorporations are the product of managers acting to maximize contractual efficiency by relocating in jurisdictions with corporate laws that are better suited to firm characteristics. Alternatively, many argue that reincorporations are used as a vehicle to relax corporate governance mechanisms and insulate incumbent managers from the market for corporate control.

In this analysis of reincorporations that occurred between 1980 and 1992, the evidence reveals that corporate managers offer a variety reincorporation motives. The shareholder wealth effects of the studied reincorporations are found to be dependent upon

these motives The findings lend situational support to both managerial entrenchment arguments and to contractual efficiency theories

In contrast to past research, the tests conducted here reveal that many reincorporations are harmful to securityholders Over 3/5 of the sampled reincorporation proposals contained at least one antitakeover charter amendment, many of which were either bundled as a part of the reincorporation plan or come in the form of hidden amendments When such reincorporations are passed for solely defensive purposes, shareholder wealth decreases by over 1 1% Further, when these plans are passed in the presence of takeover threats, security prices decline by nearly 3%

The evidence also suggests that reincorporations can result in increased shareholder wealth This is the case for those reincorporations conducted to take advantage of corporate laws that allow for limitations on director and officer liability When such proposals are passed, shareholder wealth increases by nearly 1% Further tests reveal that these reincorporations relaxed some of the constraints imposed by the crisis in the market for D&O liability insurance and assisted these firms in achieving increased levels of outside board representation

CHAPTER 1

INTRODUCTION

1.1 Introduction to the problem

This thesis is a study of the decisions made by the managers of publicly traded corporations to change their firms' state of legal domicile. Under the state chartering system in place in the United States, a substantial portion of the contractual framework governing the relations between corporate managers, shareholders, and stakeholders is determined by the corporate laws of the state where the firm is incorporated. Within this system, a change in a corporation's state of legal domicile, commonly referred to as a reincorporation, results in a change of the set of contracts governing the firm.

There are several redeeming qualities of the existing state chartering system, the most significant being that the continuum of state corporate statutes provides managers with a broad spectrum of permissible contracts from which managers can then choose the most efficient set for the firm. In this context, the optimal chartering jurisdiction for a given firm is hypothesized to be a function of several firm attributes, including: the nature of the firm's operations, its ownership structure, and perhaps firm size. It follows that, in the absence of agency conflicts, these factors should serve as the primary determinants of management's decision to reincorporate into another state.

However, due to the dispersed ownership inherent in the modern corporation, agency conflicts often play a significant role in managerial decisions. Many financial scholars have suggested that agency conflicts play an influential role in the decision to reincorporate, and that the these conflicts are exacerbated by the competition among states for the revenue generated from corporate charters.

In that scenario, liberal states engage in a competition for corporate chartering revenue on dimensions that appeal to the insecurity of incumbent management teams. Recognizing that managers sit atop the corporate decision-making hierarchy, exercising effective control over the corporate agenda and near-veto power over shareholder sponsored proposals, liberal states allegedly distinguish themselves by tailoring their corporate statutes to the interests of managers, at the expense of shareholders. This process includes providing management with a variety of mechanisms that enable managers to increase their influence over the corporation, and to minimize the threats posed by outside sources. Examples of such threats include: shareholder groups seeking to actively influence company policies, the threat of personal liability for ill-advised corporate decisions and--most of all--the threat of displacement by an outside management team. These threats, considered by many to be necessary components of the corporate governance equation, can impose substantial costs upon corporate managers, the magnitude of which may motivate them to act in a manner consistent with maximizing their own utility, via job preservation and risk reduction, as opposed to shareholder value maximization.[1]

Scholars such as Cary (1974) and Nader, Green, and Seligman (1976) conjecture that managers of corporations originally chartered in strict states frequently succumb to the enticing corporate laws of liberal jurisdictions and propose a reincorporation as a vehicle to further their own interests. If this is indeed the case, securityholders may end up suffering in these reincorporations to the extent that the relaxation of corporate governance mechanisms results in lower values for their financial claims.

Past researchers have found little evidence to support the contention that agency conflicts, coupled with competition in the market for corporate charters, motivate managers to reincorporate in manners contrary to shareholder interests. However, the conclusions reached in these studies, most of which are based on earlier time periods and on relatively small sample sizes, may not hold in the modern corporate environment.

The goal of the present analysis therefore is to reexamine the reincorporation decision, with the main emphasis placed on extending our understanding of the determinants and wealth effects of this corporate decision into the modern corporate era. The focus is on reincorporations that were conducted between 1980 and 1992, a period that encompasses several significant changes in the environment for corporate control.

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[1]Martin and McConnell (1991), Cotter and Zenner (1993), and Agrawal and Walking (1994) all document that corporate managers suffer significant wealth losses due to lost compensation when tender offers are successful. Agrawal and Walkling also find that ousted CEOs have a difficult time gaining employment in a similar capacity. In their analysis, they report that replaced CEOs usually fail to find another senior executive position with a public corporation within 3 years after their replacement.

In the analysis, the expressed and implied motives provided by management as the impetus in their proposals to reincorporate are identified. This classification is fundamental to the analysis, in that it allows for clearer tests of alternative hypotheses--tests that would otherwise convey little information due to the numerous potential motives for reincorporation and the wide degree of heterogeneity in the sample. Finally, emphasis is placed upon determining how the decision to reincorporate impacts the corporate governance mechanisms of the sampled firms. This includes not only documenting the changes in the corporate governance structure that coincide with the change in legal domicile, but also relating these changes, and the other changes that occur in the two years subsequent to the reincorporation, to the security price reactions surrounding the moves.

1.2 Relevance of the study

The decade of the 1980's ushered in significant changes in the corporate governance arena. During this period, innovations in corporate financing activities, such as junk bond financing and the use of highly-leveraged transactions, led to a substantial increase in the number of corporate control contests relative to earlier time periods. Even extremely large corporations, once thought to be immune to takeover threats due to their size, faced a reasonable possibility of being involved in a battle for corporate control. Coinciding with, and partly as a result of, the increase in corporate control activities came a substantial increase in the level of shareholder activism. Both individual and institutional investors demonstrated a desire actively to influence managerial decisions, and a willingness to scrutinize and hold managers accountable for decisions gone awry.

In response to the proliferation of control contests and the increased scrutiny of corporate decision-makers, many states revised their corporation laws during the 1980's. The most common revisions were the fortification of takeover defenses and provisions allowing for the limitation of director liability. These changes and the resultant court precedents expanded the menu of acceptable managerial actions in response to corporate control contests, and lowered the financial exposure of officers and directors to suits filed by disgruntled shareholders. The managers of many firms quickly took advantage of these revisions by moving their firms' legal corporate jurisdictions to states providing new forms of protection.[2] The exodus of firms from states lacking comparable provisions forced many such states to modify their corporate laws to provide similar protection as well.[3]

While the revisions in state corporation laws were driven by changes in the corporate environment, many argue that they continue an ongoing trend in which liberal states tailor their corporation laws to the desires of management, at the expense of the shareholder. The existing empirical evidence tends to support this notion. In their study

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[2]For example, Delaware was one of the first states to amend its corporate law to allow for director liability limitation, doing so in June 1986 (effective July 1, 1986). This change coincided with a substantial increase in the number of reincorporations to Delaware during 1986 and 1987.

[3]The state of California, frequently characterized to as a shareholder rights state, lost a large number of corporations to the state of Delaware during 1986 and 1987. The primary motive cited by the majority of these firms was director liability reduction. In response, California amended its corporate law with respect to director liability in September 1987. Other states modifying their corporate laws with respect to director liability concurrently included Pennsylvania (November 1986), New Jersey (February 1987), and Colorado (May 1987). The corporate laws of most states now include provisions allowing for director liability reduction.

of 40 second-generation state takeover laws adopted during the 1980's, Karpoff and Malatesta (1989) report that at least 70% (28 out of 40) of the bills introduced in state legislatures from 1982 to 1987 were sponsored by, or introduced on behalf of, at least one large firm either headquartered or incorporated in the state. Recent empirical studies of the shareholder wealth effects resulting from both second-generation state takeover laws and firm-level takeover defenses adopted during the 1980's suggest that liberal states, acting on the requests of corporate managers, have provided incumbent management teams with excessive protection from the market for corporate control.[4]

Unlike the evidence presented on second-generation antitakeover measures, however, existing empirical research has not clearly documented the net effect of director liability reduction measures on shareholder wealth. As a result, the impact of such measures remains unclear. Opponents argue that a management provided with liability protection is more likely to make self-serving business decisions, rather than acting in the best interests of shareholders. Conversely, proponents argue that limitations on director liability are beneficial since they enable the firm to attract and retain more qualified outside directors, once the individuals can be assured that their liability exposure will be minimal.

The large volume of reincorporations which have occurred during the last decade and a half, the majority for either antitakeover or director liability reasons, provides a rich database from which to examine the relationships among changes in state corporation

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[4]See Jarrell and Poulsen (1987), Malatesta and Walkling (1988), Ryngaert (1988), Karpoff and Malatesta (1989), and Szewczyk and Tsetsekos (1992). These studies are reviewed in chapter 3.

laws, the reincorporation decision, the attributes of reincorporating firms, and the resultant impacts on shareholder wealth. This study focuses on a large sample of firms that reincorporated since 1980, in order to address those issues.

1.3 Overview of the results

The evidence presented here reveals a variety of potential reasons for firm management to propose a reincorporation. The shareholder wealth effects of the decision to reincorporate are found to be dependent upon these managerial motives. In particular, there is support in the findings for both managerial entrenchment arguments and efficient-contracting theories.

In contrast to the findings of past research on this issue, the tests here reveal that a large number of reincorporations are harmful to securityholders. When defensive reincorporation proposals are passed, shareholder wealth decreases in excess of 1.1%. Furthermore, when these reincorporation proposals are passed in the presence of existing takeover threats, security prices decline by approximately 3%. Sixty-two percent of the reincorporation proposals conducted in the 1980's include at least one "shark repellent" (i.e., antitakeover charter amendment). These amendments are frequently bundled as a part of the reincorporation proposal or come in the form of hidden amendments.

Consistent with the efficient contracting hypothesis, evidence is also presented to suggest that a reincorporation can also be a value-adding undertaking. This is the case when reincorporations are conducted in order to reduce director liability. When such proposals are passed, shareholder wealth increases by nearly 1%. Logistic regressions reveal that firms reincorporating for director liability reasons are generally smaller, growth-oriented firms that conduct operations in technology intensive industries. These firms were the hardest hit by the crisis in the market for D&O liability insurance during the 1980's, and many had a difficult time attracting and retaining quality outside directors due to the lack of sufficient liability protection. Corporation laws that allow for limitations on director liability assisted these firms in achieving the desired level of outside representation, and as a result led to increased shareholder wealth. In support of this finding, a statistically significant increase in the level of outside board representation is documented for those firms citing director liability reduction motives for reincorporation. In contrast, there was no increase in outside representation for the remainder of the sample.

Finally, the study documents a statistically significant decrease in director and officer ownership concentration over the three-year period subsequent to reincorporation. This finding is consistent with the theory that firms move to liberal jurisdictions when ownership becomes sufficiently dispersed to make market-based governance mechanisms desirable.

1.4 Outline of the study

Chapter 2 of the study gives an overview of the theory of the contractual organization, placing particular emphasis on the collective role of contracting and market-based governance mechanisms in minimizing the agency costs inherent in corporations. The chapter also describes the existing state chartering system and its relationship to the contractual framework governing the firm. Chapter 2 concludes by examining alternative theories regarding why management would choose to alter this framework by changing chartering jurisdictions and how these theories lead to different predictions as to the effect of the decision on securityholders. Chapter 3 presents the results of past empirical research, both on reincorporating firms and on other corporate events central to the analysis. Chapter 4 then presents the hypotheses to be tested. Chapter 5 describes the sample selection process and identifies the characteristics of the sampled firms. Chapter 6 discusses the reincorporation motives offered by managers and explores how these motives may impact the welfare of securityholders. Chapter 7 provides evidence on how managers use a reincorporation as a vehicle to relax corporate governance mechanisms. Chapters 8 and 9 present the research methodology employed and the results of the empirical analysis. Chapter 10 concludes the study and summarizes the findings.

CHAPTER 2

REINCORPORATION THEORY

2.1 The firm as a nexus of contracts

Extending the work of scholars such as Coase (1937), and Alchian and Demsetz (1972), Jensen and Meckling (1976) characterize the modern corporation as a "nexus of contractual relationships," which unites both the providers and users of capital in a manner superior to alternative organizational forms. Jensen and Meckling (J&M) suggest that the existence of clearly specified contractual relationships serves to minimize the agency costs that Berle and Means (1932), among others, have identified as an unavoidable consequence of the separation of ownership and control. In their own words, J&M conclude (p. 357):

> "The publicly held business corporation is an awesome social invention. Millions of individuals voluntarily entrust billions of dollars, francs, pesos, etc., of personal wealth to the care of managers on the basis of a complex set of contracting relationships which delineate the rights of the parties involved. The growth in the use of the corporate form as well as the growth in market value of established corporations suggests that at least, up to the present, creditors and investors have by and large not been disappointed with the results, despite the agency costs inherent in the corporate form.
>
> Agency costs are as real as any other costs. The level of agency costs depends among other things on statutory and common law and human ingenuity in devising contracts. Both the law and the sophistication of contracts relevant to the modern corporation are the products of a historical process in which there were strong incentives for individuals to minimize agency costs. Moreover, there were alternative organizational

> forms available, and opportunities to invent new ones. Whatever its shortcomings, the corporation has thus far survived the market test against potential alternatives."

The insight provided by J&M is that the mix of contracts defining the firm, both express and implied, collectively serves to guide managerial actions toward those consistent with shareholder wealth maximization. Fama (1980) further refines this theory by placing emphasis on the complementary role of competitive markets in guiding corporate decision-makers toward value-maximizing strategies. These markets include product markets, the managerial labor market, and capital markets. Fama suggests that competition within these markets helps to preserve efficiency in the corporate form of organization when express contracts alone may fail, with the market for corporate control providing the discipline of last resort.

In discussing the disciplinary role of an active capital market, Fama (1978) states that if management is unsuccessful in convincing shareholders that wealth maximization is the number one priority guiding managerial decision-making, an efficient capital market will, "on average, appropriately charge the firm in advance from future departures from currently declared decision rules." This implies that managers must ensure claimholders, from the onset of corporate existence, that the firm will act solely in their interests. Otherwise, a deflated stock price will activate capital market mechanisms to restore shareholder wealth.

The preceding paragraphs illustrate the important, complementary roles that contractual relationships and market-based governance mechanisms play in maintaining managerial accountability to corporate owners. The following two sections describe (i) how the choice of corporate chartering jurisdiction influences this set of contracts, and (ii) the alternative theories as to why management may decide to change the set of contracts governing the firm by reincorporating into another jurisdiction

2.2 The market for corporate charters

In the United States, corporations conduct business under a state chartering system. Within this system, corporate laws are the province of the states. Each state has its own corporate laws and established court precedents defining the legal framework that governs the activities of corporations chartered in that jurisdiction. Thus, the corporate laws of each state provide the base set of contracts to govern the agency relationships between managers, securityholders, and other stakeholders.[5]

Corporate managers reserve the right to incorporate the firm in the state of their choice, and upon doing so, the corporate entity is free to conduct business in any state. In making the decision where to incorporate the firm, managers have a wide-ranging choice of chartering jurisdictions, each with its own corporation laws that vary among jurisdictions along a continuum from strict to liberal. States with strict corporate laws operate under the philosophy of providing for significant shareholder influence on firm

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[5]The incorporation codes and court precedents of each state provide the legal framework defining the rights of shareholders and specifying the fiduciary duties of firm management in such areas as: shareholder voting rights, the election of directors, approval requirements for business combinations and divestitures, and acceptable managerial responses to takeover attempts.

management. This frequently includes provisions in the corporate code providing for: required annual elections of directors (i.e., no staggered terms), mandatory cumulative voting, equal voting rights for all classes of shareholders, and higher voting requirements for transactions requiring shareholder approval. An example of a relatively strict jurisdiction is the state of California. California has historically maintained a policy of maximizing the role of shareholders in the corporate governance equation.

In contrast, liberal states distinguish themselves by providing managers with a great deal of flexibility in corporate affairs in general, and with regard to the corporate governance structure in particular. These provisions include: allowing lower voting approval thresholds for business combinations, permitting multiple classes of shareholders with unequal voting rights, and providing managers with the opportunity to reduce the influence of shareholders, in favor of alternative forms of governance.[6] Moreover, liberal states, as opposed to their strict counterparts, have historically sided with incumbent management in control-related issues, providing managers with a substantial degree of flexibility in dealing with unsolicited takeover attempts and buttressing the positions of incumbent managers with restrictive state takeover statutes.

Once management has chosen its state of incorporation, the corporation must pay an annual chartering, or franchise fee, to that jurisdiction. There is a great deal of variation in the magnitude of these fees among the states, with the most liberal states such as Delaware typically commanding much larger fees than other states. Currently,

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[6]For example, two common methods that are used to reduce shareholder influence are the elimination of cumulative voting rights, and classification of the board of directors.

Delaware corporate chartering fees are based on a variable rate system, where the fee is dependent upon the amount of firm capitalization. Corporations beyond a threshold level of capitalization pay the maximum annual fee of $150,000. While the annual fees imposed upon Delaware corporations are quite large relative to the trivial fees charged by many other jurisdictions, they are often viewed as a premium extracted in return for Delaware's well defined body of corporate case law and its preeminence in corporate affairs. Posner and Scott (1980) offer this rationale to explain the preponderance of large, NYSE listed firms that are incorporated in Delaware. In their view, for sufficiently large firms, the additional Delaware tax burden is more than offset by the benefits of corporation laws that are specifically tailored for large public companies.

2.3 Alternative theories on the decision to reincorporate

Because of the significant differences in corporation laws from state to state, the decision to reincorporate can materially change the nexus of contracts comprising the firm. As a result, the impact of the decision on shareholder wealth has been the subject of debate. On the one hand, many financial scholars and legal researchers contend that competition in the market for corporate charters produces a wide variety of potential contractual relationships from which the firm will choose the legal domicile that serves to minimize organizational costs, thus maximizing firm value. Proponents of this viewpoint include Dodd and Leftwich (1980), Easterbrook and Fischel (1983), Baysinger and Butler (1985) and Romano (1985). This 'contractual efficiency' argument suggests that firms electing to reincorporate do so when firm characteristics are such that the change in legal jurisdiction increases shareholder wealth by lowering the collection of legal, transactional, and capital-market-related costs As a result, arguments of contractual efficiency imply the existence of a relationship between firm attributes (e.g., ownership structure, nature of business) and the firm's choice of legal residency.

A widely held opposing view is that a change in corporate charter often leads to a reduction in shareholder wealth due to its relaxation of the contractual mechanisms that govern the agency relationships of the firm. Proponents of this viewpoint suggest that managers will attempt to move the firm to a more liberal, or "pro-management" jurisdiction in order to relax the firm's governance mechanisms and provide managers with a greater degree of insulation from shareholder influence and capital market discipline. Scholars such as Cary (1974) identify the source of this problem as unhealthy competition among the states for the revenue generated from chartered firms.[7] Cary contends that liberal states compete in a so-called "race to the bottom," in which states entice management to incorporate, or reincorporate, in their jurisdiction by providing a legal environment with the fewest possible checks on managerial discretion. The result of this race to the bottom is a gradual relaxation of the governance mechanisms necessary to maintain managerial accountability to shareholders. The main prediction of this argument is the existence of legal corporate jurisdictions in which pro-management chartering

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[7]The revenue generated from franchise taxes and incorporation fees can represent a substantial portion of state revenues, particularly for corporate environments such as Delaware. For example, according to an article in *Ohio Business* (Wasnak, 1988), income from franchise fees and incorporation fees represented 15% of Delaware's annual budget for the year 1988.

provisions lower shareholder wealth.[8] The corollary prediction is that the reincorporation decision for many firms (those that change jurisdictions to take advantage of pro-management statutes) will reduce shareholder wealth.

Each of these arguments provides testable hypotheses regarding the chartering behavior of modern corporations. The increasingly pro-management trend in the corporate laws of liberal states during the last decade and a half has magnified the potential importance of the corporate chartering decision, and justifies further investigation.

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[8]Bebchuk (1992) points out several areas where competition for corporate charters leads to suboptimality in the corporate environment. Specifically, he suggests that one area in which state competition fails is with respect to issues that effect the functioning of market discipline, such as the regulation of takeover attempts and proxy contests.

CHAPTER 3

PRIOR EMPIRICAL RESEARCH

This chapter provides a review of the existing empirical evidence which is central to the analysis. The goal of the review is not only to revisit the findings of prior researchers who have examined reincorporations, but also to discuss the results of other studies whose findings bear on the research issues addressed here. The purpose of this approach is to establish how the motives for, and wealth effects of, the reincorporation decision may now differ from what has been reported in earlier analyses, because of significant recent developments in the corporate control environment. Thus, in addition to providing a historical perspective, the chapter also develops the rationale for conducting the present study.

3.1 Reincorporation research

3.1.1 *Reincorporation and shareholder wealth*

Thus far, empirical research has failed to document significant evidence in support of arguments that reincorporations are conducted to entrench management to the detriment of shareholders. Instead, existing evidence tends to suggest that the decision to change the corporate domicile has, on average, a non-negative effect on shareholder wealth. The remainder of this section provides a chronological review of the relevant evidence.

In an early empirical study conducted on reincorporating firms, Dodd and Leftwich (1980) analyzed a sample of 140 NYSE listed firms that reincorporated during the period 1927 to 1977 and found no evidence of shareholder wealth reduction as a result of the decision. Indeed, the authors documented a positive and statistically significant cumulative abnormal return (CAR) on the common stock of the reincorporating firms averaging 30.25% in the 25 months preceding and including the month of the reincorporation. Further analysis revealed that the abnormal returns during the month of the change and surrounding the day of the change were insignificantly different from zero. Collectively, the results led Dodd and Leftwich to conclude that managers "take advantage of the competition among the states to locate in a state which offers an efficient set of restrictions on the firm, given the firm's anticipated production-investment and financing activities" [p. 282].

Romano (1985) conducted an analysis of 465 NYSE, AMEX, and OTC firms that changed their legal domicile during the period 1961 to 1983, although with limited data from 1980 onward. The sample of 465 firms included firms whose reincorporation was associated with an initial public offering (IPO). 150 of the sampled firms were either NYSE or AMEX listed at the time of the event. Of those firms, 63 reincorporated to facilitate mergers or acquisitions, 43 for antitakeover purposes, 21 for tax reasons, and 23 for other listed motives. Romano's analysis indicated that abnormal returns for the sample of 150 firms cumulated to 4.1% over the event window -90 to +90 surrounding the earliest mention of the proposed reincorporation. When broken down into categories, reincorporations classified as facilitating mergers or acquisitions had abnormal returns cumulating to +8.6%, those in the antitakeover category cumulated to +1.3%, and those for tax purposes cumulated to +0.6%. For the event window -10 to +10, only the +6.7% CAR of firms reincorporating to facilitate acquisitions or mergers was statistically significant. Based on the results of her analysis, Romano concluded that the decision to reincorporate is at worst "a zero net present value transaction" [p. 273].

Peterson (1988) examined a sample of 30 firms that reincorporated in Delaware over the period 1969 to 1984. Peterson identified three primary motives for reincorporation: antitakeover measures, cost reduction measures, and increased managerial flexibility. For the 14 firms in the sample with stated antitakeover intentions, the abnormal returns on their shares did not differ significantly from zero on any day in the event window considered. The other 16 firms, however, experienced positive abnormal returns (10% significance level) for three days in the event window. These results led Peterson to conclude that, "the benefits obtained through reincorporation are offset by the detrimental effects of takeover defenses" [p. 160].

Netter and Poulsen (1989) examined the shareholder wealth effects of reincorporation in Delaware. Their sample consisted of 36 NYSE and AMEX firms that reincorporated to Delaware in 1986 and 1987. Netter and Poulsen documented cumulative stock abnormal returns over the two years prior to the reincorporation averaging -17.7%. While this CAR was not significantly different from zero, it does conflict with Dodd and Leftwich's earlier findings of 30% positive CARs for the two years prior to reincorporation. In contrast to the two-year cumulative results, Netter and Poulsen found positive and significant CARs (at the 10% level) of 5.67% over the 25-day event window -20 to +5 surrounding the date that the proxy materials were mailed to shareholders. Netter and Poulsen concluded that the evidence did not reveal any negative wealth effects associated with the decision to reincorporate.

3.1.2 *Evidence on when and why firms reincorporate*

Although the decision to reincorporate has received a reasonable amount of attention from financial researchers, the primary emphasis in these analyses has been to identify how this decision effects security prices. An equally important question, and one left relatively unanswered empirically, is; why managers elect to reincorporate and what prompts them to make the decision when they do?

The historical evidence that reincorporating has not, on average, harmed shareholders lends support to those financial researchers and legal scholars in the 'contractual efficiency' camp. This group includes: Dodd and Leftwich (1980), Fischel (1982), Easterbrook and Fischel (1983), Baysinger and Butler (1985), and Romano (1985). The commonality among their theories is that management's choice of chartering jurisdictions is a function of firm attributes and that, based on these attributes, managers choose the chartering jurisdiction in which firm activities can be most efficiently conducted. However, the body of empirical evidence actually to support the notion of the existence of a relationship between firm attributes and the choice of chartering jurisdiction is relatively small.

In their 1980 study, Dodd and Leftwich (D&L) document an unusually high frequency of shifts in the betas of their sample firms, subsequent to reincorporation. This is interpreted as evidence that reincorporating firms in general are undergoing changes in either their operating activities or financial structure. According to D&L, it is the anticipation of these changes that lead managers to relocate into another jurisdiction, with that jurisdiction being one that offers a more efficient set of conditions on the operation of the firm than its original state of incorporation.

Romano (1985) arrives at a similar conclusion. In what Romano refers to as a "transaction explanation of reincorporation", she suggests that firms change their state of incorporation "at the same time they undertake, or anticipate engaging in, discrete transactions involving changes in firm operation and/or organization" [p.226]. According to Romano, firms choose to migrate at these times to destination states where the corporation laws allow the changes in corporate policies or activities to be pursued in a more cost-efficient manner. She suggests that, due to the expertise of Delaware's judicial system and its well-established body of corporate law, Delaware stands out as the most favored destination state when changes in corporate policies or activities may increase the likelihood of legal impediments. As evidence, Romano cites the high frequencies of reincorporations coinciding with specific corporate events such as initial-public-offerings (IPOs), mergers and acquisitions, and the adoption of antitakeover measures. In support of her theory, Romano also provides evidence that large Delaware-incorporated firms conduct a significantly higher number of acquisitions than non-Delaware firms.

Baysinger and Butler (1985) offer a slightly different twist on the contractual efficiency argument. They hypothesize that the choice of strict vs. liberal jurisdiction is a function of the firm's residual claimants. They contend that states with strict corporate laws are better suited for firms with concentrated ownership structures, whereas liberal jurisdictions promote efficiency when ownership becomes dispersed. According to their theory, large blockholders will prefer the pro-shareholder laws of strict states since these laws provide shareholders with the explicit legal controls needed to exercise their "voice option" and actively influence corporate affairs. As a result, they suggest that firms chartered in strict states are likely to stay there until share concentration decreases to the point that legal controls may be relaxed, in favor of market-based governance mechanisms.

Baysinger and Butler (B&B) test their hypothesis by comparing several measures of ownership concentration in a matched sample of 302 manufacturing firms, half of which were incorporated in strict states (California, Illinois, New York, and Texas), with the other half having migrated out of these states. In support of their hypothesis, they find that those firms that stayed in strict states exhibited significantly higher proportions of voting stock held by members of identifiable family groups, held closely, and held by other corporations, than their matched counterparts that elected to relocate out of strict states. B&B also report that the financial performance did not differ between these two groups. Collectively, they interpret the results as evidence that the corporate chartering decision is a function of ownership structure and, as a result, the choice of strict vs. liberal jurisdictions is not related to firm performance.

3.2 Related research

Along with the existing reincorporation literature, there are several peripheral issues that are of significance to the present analysis. The significance comes in the form of evidence that, during the 1980's, liberal states consistently chose to side with management in control-related issues. During this period, liberal states substantially altered the activity in the market for corporate control by both validating controversial firm-level takeover defenses with court precedents and, later, by arming managers with restrictive state-takeover legislation. The empirical evidence reviewed in the following three sections suggests that these actions were not in the best interests of securityholders.

In addition to the review of the developments in the market for corporate control provided in sections 3.2.1, 3.2.2, and 3.2.3, section 3.2.4 provides a review of the empirical literature conducted to determine the wealth effects of director liability reduction measures. A substantial portion of the reincorporations that occurred during the 1980's were conducted in order to take advantage of state corporation laws providing for limitations on director liability.

3.2.1 *Court precedents*

On two different occasions during 1985, the Delaware Courts validated then-controversial firm-level takeover defenses. Several authors have documented that these pro-management rulings were not in the best interests of the shareholders of firms likely to be involved in control contests. For example, Kamma, Weintrop, and Wier (1988) and Ryngaert (1989) report significantly negative security price reactions of -2.4% and -1%

for shareholders of takeover targets incorporated in Delaware, in response to the Delaware Supreme Court's pro-management ruling in the *Unocal vs. Mesa* case.[9] In *Unocal vs. Mesa*, the court upheld Unocal's discriminatory stock repurchase in response to Mesa's hostile acquisition attempt, in an interpretation of the "business judgment" rule. Ryngaert (1989) reports similar losses to shareholders of Delaware-incorporated takeover targets in response to the Delaware Court's ruling in the *Moran vs. Household* case.[10] In the *Moran* case, the Delaware Court validated Household International's use of a poison pill defense as an acceptable corporate response to a takeover attempt.

Collectively, the precedents established in both the *Unocal* and *Moran* rulings revealed the willingness of the Delaware Court to uphold the legality of second-generation firm-level takeover defenses based on the application of the business judgment rule. As a result of these established precedents, many firms were quick to adopt similar types of takeover deterrents.[11] Moreover, these precedents increased the attractiveness of the state of Delaware to the managers of corporations likely to be involved in corporate control contests, and this has no doubt been influential in the decisions of managers to move their state of incorporation to Delaware.

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[9] *Unocal vs. Mesa Petroleum* 493 A.2d 946 (Del. 1985).

[10]*Moran vs. Household International* 500 A.2d 1346 (Del. 1985).

[11]Ryngaert (1988) reports an 850% increase in the use of poison pill plans from the time of the Moran vs. Household ruling (November 1985) until the end of 1986. At the end of 1986, over 380 corporations had adopted poison pill plans, in contrast to only 40 prior to the Court's decision.

3.2.2 *Firm-level takeover defenses*

Numerous authors have analyzed firm-level takeover defenses in an attempt to determine if they are in the best interests of shareholders. The collective evidence suggests that security price reactions to these mechanisms have become increasingly negative over time, as new, more powerful deterrents were developed.

Evidence on antitakeover measures adopted prior to 1980

The early studies of DeAngelo and Rice (1983) and Linn and McConnell (1983) found no statistical evidence to suggest that antitakeover amendments adopted prior to 1980 were harmful to shareholders. DeAngelo and Rice examined 100 firms that adopted antitakeover amendments during the period 1974-1978. They report that shareholders of these firms experienced statistically insignificant abnormal returns averaging -0.16% over a two-day event window including the day of, and the day after the proxy mailing. Abnormal returns over longer event windows, while negative, were also insignificantly different from zero. Linn and McConnell (1983) conducted a similar analysis on a larger sample of 475 firms that adopted antitakeover amendments over the period 1960-1980. Due to the difficulty in identifying precise information dates, they examine abnormal stock returns over several event windows throughout the amendment process. They report significant abnormal returns of 1.43% (based on a subset of 307 firms) for the interval beginning with the proxy mailing date and ending one day prior to the date of the stockholders meeting, and predominantly positive returns over numerous other windows.

In sum, the results of their analysis suggest that over the period from 1960-1980, antitakeover charter amendments, on average, led to a small, yet significantly positive revaluation in the security prices of adopting firms. This finding led Linn and McConnell to conclude that "antitakeover amendments are proposed by managers who seek to enhance shareholder wealth and approved by rational stockholders who share that objective" [p.397].

<u>**Evidence on antitakeover measures adopted after 1980**</u>

In contrast to the evidence that antitakeover measures adopted prior to 1980 did not harm shareholders, the results of later analyses suggest that firm-level takeover defenses enacted since 1980 have, on average, elicited significantly negative security price reactions. This includes both antitakeover charter amendments subject to shareholder approval, and defenses such as poison pills, that may be enacted at the discretion of management. The most notable studies of post-1980 firm-level takeover defenses include: Jarrell and Poulsen (1987), Malatesta and Walkling (1988), and Ryngaert (1988).

Jarrell and Poulsen (1987) analyze the wealth effects of antitakeover charter amendments adopted in the period 1979-1985. Using a 31 day event window spanning 20 days prior to through 10 days after the proxy signing date, they find a significantly negative average security price reaction of -1.25% for their sample of 551 firms.[12]

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[12]Numerous shorter windows were also examined. While the signs of the abnormal returns across categories were consistent with those found for the longer 31-day window, the magnitudes of the abnormal returns in the shorter windows were not statistically different from zero.

Moreover, they report that this reaction is driven primarily by those firms (143) adopting non-fair-price amendments. The securityholders of firms proposing non-fair-price amendments experienced significantly negative abnormal returns averaging -2.95%, whereas the securityholders of firms proposing less restrictive fair-price amendments, experienced insignificant declines in the values of their shares averaging -0.65%.[13]

After the 1985 Delaware Court precedent established in *Moran vs. Household* validated the use of poison pill plans as an acceptable managerial response to unsolicited takeover attempts, the managers of a substantial number of corporations have adopted poison pills, despite the overwhelming evidence that such plans are not in the best interests of securityholders.[14] Malatesta and Walkling (1988) and Ryngaert (1988) provide

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[13]Fair-price amendments are designed to protect shareholders from the collective choice problem that arises with two-tier tender offers. In the 'front-end' of a two-tiered tender offer, the bidder specifies a price that it will pay for all target shares tendered up to a specified percentage of the total outstanding shares, or until the expiration of the tender offer. Shareholders that do not tender their shares by this time are caught in the 'back-end' of the tender offer, and are offered a lower price for their shares when the acquirer attempts to purchase the remainder of the outstanding shares in a subsequent merger or tender offer. Thus, two-tiered offers coerce shareholders to tender their shares early, as opposed to holding out, in order to avoid getting caught in the back end of the transaction and receiving substantially less for their shares. Fair-price amendments solve this collective choice problem by requiring supermajority approval for all multi-tier tender offers that are not approved by the target's board of directors. In order to avoid the supermajority requirement, the bidder must treat all shareholders fairly, regardless of when they choose to tender their shares, by paying a uniform price for all shares tendered. On the other hand, non-fair-price amendments are considered more restrictive since they impose substantial costs on a potential acquirer regardless of whether or not the bid treats all shareholders equally. The most common non-fair price amendments include: supermajority amendments, classified board amendments, authorization of blank-check preferred stock, and the elimination of cumulative voting procedures.

[14]Unlike antitakeover charter amendments, poison pill plans may be enacted by firm management without prior shareholder consent. According to figures provided by the Investor Responsibility Research Center (IRRC), the management of 795 out of the 1500

evidence that these firm-level defenses reduce stockholder wealth by statistically significant amounts. Malatesta and Walkling examined 113 firms that enacted poison pill defenses between December 1982 and March 1986. They report a statistically significant decline in shareholder wealth averaging -0.915% over the two day window including the day before, and the day of, the plans' announcement. Ryngaert presents similar results in his analysis of 380 poison pill plans adopted from 1982 through the end of 1986. Overall, Ryngaert reports a statistically significant decline of -0.34% in the value of security prices during a two-day window at the announcement of the pill plan. The negative reaction is even more pronounced for firms facing existing takeover pressures. The shareholders of firms facing takeover threats experienced statistically significant losses averaging -1.51% upon the announcement of the pill plans. Ryngaert also provides evidence that poison pill defenses have proven effective in fending off unwanted takeover attempts. He reports that the most restrictive types of poison pills are associated with abnormally high frequencies of defeat of unsolicited tender offers.

3.2.3 *State takeover legislation*

In addition to allowing managers increased flexibility in erecting firm-level takeover defenses, many states have also buttressed the positions of corporate managers with restrictive state takeover legislation. Numerous studies have found these laws to be

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large corporations tracked by the IRRC had adopted poison pill plans by the end of 1993 [*IRRC's Corporate Takeover Defenses* (1993)].

harmful to shareholder wealth, the most notable and comprehensive study being that of Karpoff and Malatesta (1989).[15]

Karpoff and Malatesta (K&M) conducted a study of second-generation takeover laws introduced in numerous states between 1982 and 1987. They report that corporations incorporated in states introducing takeover legislation experienced statistically significant stock price decreases at the initial press announcements. Furthermore, they provide evidence that the managers of large corporations pressure state legislatures to pass these restrictive laws, through both active lobbying and possibly by threatening to change corporate jurisdictions. For 28 out of the 40 takeover bills analyzed in their study, K&M are able to identify at least one large firm that was instrumental in getting the legislation introduced. In all of these cases, the influential firm was either headquartered or incorporated in the state crafting the antitakeover laws. K&M estimated the total loss to shareholders attributable to the state takeover laws analyzed in their sample to be $6 billion. This finding suggests that liberal states may at least initially have gone too far in their efforts to protect existing management from control contests.

Additional evidence in support of managerial entrenchment arguments is documented by several authors surrounding the passage of Pennsylvania Senate Bill 1310. This pro-management, third-generation takeover legislation was a supplement to the existing Pennsylvania antitakeover statutes in response to the hostile takeover attempt of

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[15]For additional evidence, see Schumann (1989), Ryngaert and Netter (1988, 1990), and Woodward (1990).

Armstrong World Industries, a Pennsylvania incorporated firm.[16] In addition to strengthening management's position in a hostile takeover attempt, the amendment also provided provisions guaranteeing severance pay and the continuation of existing labor contracts in the event of a successful takeover. The pro-management nature of SB1310 led to heated opposition from large institutional investors such as the California Public Employees Retirement System (CALPERS), which voiced concern that shareholder ability to influence managerial actions had diminished.[17] Szewczyk and Tsetsekos (1992) provide evidence that the passage of SB1310 significantly reduced shareholder wealth. Their sample of Pennsylvania incorporated firms significantly underperformed their control sample by 3.33% over the events analyzed. Similarly, Karpoff and Malatesta (1990) report that during the legislation process, the stock prices of Pennsylvania firms underperformed the S&P 500 index by 5.8%. Szewczyk and Tsetsekos (1992) estimated the total abnormal shareholder losses over the legislation period for Pennsylvania firms to be roughly $4 billion.

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[16]State takeover legislation is considered first generation if it was enacted before the Supreme Court ruled the Illinois antitakeover law unconstitutional in 1982 in *Edgar vs. Mite [457 U.S. 624 (1982)]*. Takeover legislation enacted after the *Edgar vs. Mite* decision and prior to the 1987 Supreme Court ruling in *CTS Corp. vs. Dynamics Corp. [481 U.S. 69 (1987)]* is generally considered to be second-generation. In *CTS Corp. vs. Dynamics Corp.*, the Supreme Court validated Indiana's Control Share Acquisition Statute as constitutional. Takeover legislation passed after this ruling is considered third-generation.

[17]CALPERS asked many large Pennsylvania Incorporated firms to opt out of the law's provisions. In addition, the head of Pennsylvania's state employee retirement system suggested that if the bill were passed, his duty to investors would lead him to oppose further investments in Pennsylvania incorporated firms.

Viewed collectively, the empirical evidence provides nearly overwhelming evidence that many states have provided managers with increasingly restrictive takeover laws, and that these laws harm shareholders. The evidence also suggests that state corporation laws can significantly impede the functioning of capital market governance.

3.2.4 *Director liability reduction measures*

Since a large number of the reincorporations during the 1980's were conducted for director liability reduction reasons, that motive is particularly important to the current study. This section provides a review of the empirical literature in the area.

Many legal scholars suggest that the potential for legal liability plays a significant role in motivating directors and officers to act in the interests of shareholders. As a result, they are opposed to measures that may be used to reduce this influence on corporate governance. On the other hand, there are several compelling reasons to support limitations on director liability. By limiting the exposure to nuisance suits, these provisions can both increase the willingness of managers to take sufficient risks and improve the firm's ability to attract and retain qualified directors. The empirical evidence on the effects of reducing director and officer (D&O) liability exposure is inconclusive.

Bhagat, Brickley, and Coles (1987) examined the wealth effects on shareholders for a sample of firms that purchased D&O insurance and/or broadened managerial indemnification between 1967 and 1982. The authors report marginally significant positive abnormal returns for their sample in the two months preceding the announcement of the purchase of D&O insurance. The stock price reactions for the firms that expanded indemnification rights were insignificantly different from zero.

Using a slightly different approach, Janjigian and Bolster (1990) compared the performance of Delaware firms with that of non-Delaware firms during the legislative process in Delaware in which the state drafted its director liability statutes. The authors report that the shares of Delaware firms performed worse than those of non-Delaware firms over this period, although the magnitude of the underperformance was not statistically significant.

Netter and Poulsen (1989) examined a sample of 88 Delaware-incorporated Fortune 500 firms that adopted director liability reduction provisions in 1986 and 1987. They found that the shareholder wealth effect was insignificantly different from zero at the time the proposals were submitted to shareholders.

Finally, a more recent study conducted by Brook and Rao (1994) suggests that, on average, the market reaction to director liability reduction provisions does not significantly differ from zero. However, cross-sectional analysis reveals a significant positive market reaction for the subset of firms that are performing poorly. In light of their findings, Brook and Rao conclude that underperforming firms are significantly more likely to face the threat of shareholder lawsuits and, as a result, benefit to a greater extent from director liability provisions.

Collectively, the empirical evidence on director liability reduction measures provides mixed results. This is due in part to the nature of such analyses. In all of the existing studies, the sampled firms were already incorporated in the jurisdiction that allowed the director liability amendments. This leads to the possibility that the adoption of such amendments was anticipated, and as a result, the magnitude of the reaction would tend to be underestimated and less likely to differ significantly from zero. The analysis here of reincorporations circumvents this problem, since the adoption of director liability reduction amendments is not likely to have been anticipated, given that the company's former state of domicile did not offer such possibilities in its corporate law.

3.3 Current state of the literature

The evidence presented in the preceding review is not inconsistent with theories that many states have participated in a "race to the bottom" with respect to control-related issues. During the last decade and a half, numerous states, in response to the pressures of influential corporate managers and to the perceived need for parity in state corporation laws, have crafted restrictive takeover statutes that have proven to be effective impediments to capital-market-based discipline. Corporate managers have also shown a propensity to take advantage of liberal corporate laws and established court precedents in erecting value-decreasing firm-level takeover deterrents. Shareholders, on the other hand, have lost out. Numerous empirical studies conducted surrounding pro-management court precedents, firm-level takeover defenses, and state takeover laws provide evidence that shareholder wealth decreases by significant amounts when liberal states provide and allow for restrictions on corporate governance mechanisms.

In light of this apparent support for race to the bottom arguments, one would expect to find evidence that some managers use a reincorporation as a vehicle to further their own interests by taking advantage of liberal corporation laws that provide the opportunity to relax corporate governance mechanisms. In contrast to these expectations, the bulk of the research on this issue finds that historically, this has not been the case. However, all of the existing studies have either:

(1) failed to consider the relationship between motives, firm attributes, and shareholder wealth;

(2) examined samples pre-dating the recent changes in the corporate laws of many states; or

(3) involved relatively small sample sizes.

Thus, the current state of the literature may be summarized in the following Figure:

Figure 1

State of the reincorporation literature

Authors	Sample period	Sample size	Identified firm motives	Considered firm attributes	Conducted since 2nd generation takeover laws	Conducted since the director liability crisis
Dodd and Leftwich (1980)	1927-1977	140	no	no	no	no
Romano (1985)[a]	1961-1983	150	yes	no	no	no
Peterson (1988)	1969-1984	30	yes	no	no	no
Netter and Poulsen (1989)	1986-1987	36	no	no	yes	yes

a. Romano's sample totals 465 firms, however, since a large proportion of the firms in her sample were conducted prior to an IPO, security price information was available for only 150 firms.

With the exception of Netter and Poulsen's analysis, all these studies were conducted prior to both the advent of second-generation takeover defenses and the mid-1980's crisis in the market for D&O liability insurance. As a result, the findings of these studies may be "dated" in the sense that they may not hold in the post-1980 corporate environment where the two dominant motives for reincorporation were antitakeover purposes and to reduce director liability exposure.

Although Netter and Poulsen's analysis was conducted on firms reincorporating into Delaware after the advent of second-generation takeover defenses and the crisis in the market for D&O insurance, they do not distinguish between the reincorporating firms in the sample based on their stated motives for the move. The extant literature, however, suggests that firms electing to reincorporate should fall into two groups: (1) those driven by efficient contracting motives; and (2) those driven by managerial entrenchment motives. Reincorporations of the first sort would be expected to have positive effects on shareholder wealth, whereas those of the second type would be expected to lower shareholder wealth. If one lumps these two groups together, as in Netter and Poulsen's study, the average shareholder wealth effect may well turn out to be insignificant. Such findings do not, however, necessarily imply that reincorporations have unimportant effects on shareholders' wealth. As this analysis will later document, the market reaction to the decision is dependent upon the motive cited by management. Moreover, the 36 firm sample examined by Netter and Poulsen consists of only NYSE and AMEX firms that moved to Delaware. By contrast, in the larger sample studied here, many of the firms that reincorporated are smaller firms traded on NASDAQ, and moved to jurisdictions other than Delaware.

3.4 Chapter summary

This chapter identified several gaps in the empirical literature on the reincorporation decision and raised the question of whether or not the results of prior studies hold in the modern corporate era. These gaps and unanswered questions provide the motivation for the current study. The sample selected and the empirical tests conducted here are designed to extend our understanding of the motivations for, and the wealth effects of the reincorporation decision in the post-1980 corporate environment.

CHAPTER 4

HYPOTHESES DEVELOPMENT

This chapter presents the hypotheses to be tested in the study. The review of the alternative theories in section 2.3 of Chapter 2 illustrates that financial researchers and legal scholars have been divided with regard to their theories of reincorporations on two primary issues; how reincorporations effect shareholder wealth, and why managers choose to reincorporate. These opposing theories are captured in the context of two competing hypotheses, both offering different predictions of how reincorporations should effect securityholders, and what motivates the decision to reincorporate. In this analysis, I refer to these alternative hypotheses as the *Contractual efficiency hypothesis* and the *Managerial entrenchment hypothesis.*

Contractual efficiency hypothesis:

> Managers take advantage of the differences in state corporation laws by incorporating in the jurisdiction that provides the most efficient contractual framework for the firm. Managers reincorporate when the new contractual framework under the corporate laws of the destination state provides for expected benefits in excess of the out-of-pocket expenses attributable to the reincorporation.

The contractual efficiency hypothesis owes much of its intuitive appeal to its close resemblance to the widely-accepted financial decision-making axiom called the market value criterion, or NPV rule. In addition, the contractual efficiency hypothesis is rather robust since there are several potential benefits that may arise as a result of a change in chartering jurisdictions. These benefits, which vary across firms, may arise out of; tax savings, lower legal expenses as a result of flexible and predictable corporate laws, lower transaction costs, increased financing flexibility, and numerous other sources.

The opposing viewpoint is captured in the following hypothesis.

Managerial entrenchment hypothesis:

> Managers take advantage of the competition in the market for corporate charters by reincorporating into a liberal state in order to relax the corporate governance structure and lower their exposure to both shareholder influence and market-based governance mechanisms.

The crux of the managerial entrenchment hypothesis is that agency conflicts play a significant role in the decision to reincorporate and this role is amplified by the apparent race to the bottom in state corporation laws. As a result, when managers have the opportunity to reduce their exposure to outside threats by altering the contractual composition of the firm, they will do so. The pro-management corporation laws and court precedents of liberal states provide this opportunity. The managers of firms originally chartered in jurisdictions with strict corporate laws may reincorporate to liberal jurisdictions for these reasons.

These alternative hypotheses (contractual efficiency vs. managerial entrenchment) offer differing predictions as to the shareholder wealth effects of reincorporation and the reasons why managers would propose to reincorporate the firm. Those issues are addressed in the following two sections. Section 4.1 develops the competing hypotheses concerning how reincorporation effects shareholder wealth and section 4.2 develops the hypotheses concerning the role that firm attributes play in the decision to reincorporate.

4.1 The effect of reincorporation on shareholder wealth

The contractual efficiency hypothesis suggests that reincorporations should have a non-negative effect on shareholder wealth due to increased efficiency and/or direct cost savings. In contrast, the managerial entrenchment hypothesis predicts that reincorporations are conducted to protect incumbent managers, and that reincorporations conducted for these reasons should negatively impact security prices due to the relaxation of the corporate governance mechanisms necessary to align managerial actions with shareholder interests.

The existing reincorporation research discussed in section 3.1 of chapter 3 documents that, historically, reincorporations have on average elicited non-negative security price reactions. These findings have led researchers to reject managerial entrenchment arguments in favor of contractual efficiency theories. However, the empirical evidence discussed in section 3.2 raises the question of whether or not these past findings are still valid. The evidence in section 3.2 suggests that antitakeover measures adopted both at the firm and state level have, during the 1980's, led to significant decreases in shareholder wealth. Since the majority of reincorporations involve defensive maneuvering, and subject the firm to liberal corporation laws, it would be puzzling to find that these actions are not contrary to shareholder interests. Alternatively, a significant number of reincorporations do not include defensive maneuvering, and instead, are conducted for purposes consistent with contractual efficiency theories. In these cases, the reincorporation should be beneficial to shareholders. Thus, the shareholder wealth effects of reincorporation should be dependent upon the underlying managerial motive for the move.

As pointed out in chapter 3, the samples in prior reincorporation studies are either based on time periods preceding second generation takeover measures and the director liability crisis, or fail to disaggregate the reincorporating firms according to managerial motives. The following hypotheses are therefore derived out of the alternative theories and empirically tested on a more recent sample in which firms are classified according to reincorporation motives. They imply that the shareholder wealth effects of reincorporation are dependent upon the motive behind the change in corporate jurisdictions.

> **Hypothesis 1:** Managers reincorporate at times when the change in corporate jurisdiction reduces the contracting costs to the firm. Reincorporations conducted for these motives will have a non-negative effect on shareholder wealth, with the magnitude of the abnormal security price reactions reflecting the expected benefits from increased contractual efficiency.

> **Hypothesis 2:** Managers use reincorporations as a vehicle to adopt firm-level takeover defenses and subject the firm to the restrictive state takeover laws of liberal states in order to protect themselves from the market for corporate control. Reincorporations for these reasons have, during the last decade-and-a-half, been harmful to securityholders.

Chapter 6 presents a discussion of the express and implied reincorporation motives of firms. In that discussion, reincorporation motives are matched with the above-listed hypotheses according to their apparent consistency with either contractual efficiency or managerial entrenchment arguments. The hypotheses are then empirically tested in chapter 9.

4.2 Firm attributes and the decision to reincorporate

The literature has proposed that corporate managers elect to change the corporation's legal jurisdiction when firm attributes (such as size, operating and financing activities, and ownership structure) make the change desirable. However, existing research has failed to identify empirically what firm attributes influence the decision. Instead, it appears that the lack of an overall negative reaction to the decision has been accepted as evidence that the jurisdictional change is carried out when it is contractually efficient. In contrast to those proposing contractual efficiency arguments, researchers who suggest that reincorporations are conducted to entrench management do not hypothesize any systematic relationship between firm attributes and the decision to relocate. Perhaps the defining characteristics of this set of firms are simply poor managerial performance, higher levels of agency conflicts, and incorporation in a state that does not permit management to erect takeover restrictive takeover defenses.

Given the apparent lack of understanding of the firm attributes that influence the reincorporation decision, the purpose of this section is to entertain a variety of possible relationships between firm characteristics and the desire to change legal domicile. Consistent with the opposing stances in the literature, a distinction will be made between those firms whose actions should be consistent with contractual efficiency arguments and those whose actions should be consistent with managerial entrenchment efforts.

4.2.1 *Attributes of firms that reincorporate for contractual efficiency reasons*

Based on the fact that most firms elect to move to a more 'liberal' corporate jurisdiction from a 'strict' jurisdiction (e.g., 42% of the firms in the current sample left California, a shareholder rights state), the objective here is to identify the firm characteristics which might influence such a move.[18] In doing so, emphasis will be placed on firm characteristics and how they relate to the differences in corporate laws among the states.[19]

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[18]Relative to numerous other states, the corporate laws of California are considered to be pro-shareholder. The California corporation laws have traditionally contained provisions designed to ensure managerial accountability to shareholders. For example, during the 1980's, California law mandated cumulative voting, did not permit staggered terms for directors, and did not provide the antitakeover flexibility of many other states. However, largely in response to the large exodus of firms from California for director liability reasons, California amended its corporate law to include director liability provisions in September of 1987. However, the amended California law contains several exclusions and, as a result, does not provide managers with the level of protection available under the Delaware code. The California laws were also amended in January of 1990 to permit certain qualifying corporations to eliminate cumulative voting by adopting amendments to their articles of incorporation or bylaws.

[19]Delaware has demonstrated its responsiveness to changes in the corporate environment on numerous occasions by being the initial state to introduce specific types of changes in its corporation law. For example, Delaware was one of the first states to introduce provisions allowing for the reduction of director liability and indemnification of officers and directors. Delaware has also demonstrated a first-mover tendency in control-related issues. There is no doubt that this first-mover tendency is responsible for a substantial portion of the reincorporations into Delaware. Romano (1985) provides evidence that the trend in the number of, and the motives for, reincorporations over time is closely related to the pattern of innovations in corporate laws. She and suggests that this is indicative of a diffusion process in state corporation laws due in part to the competition for corporate

As is evident from the discussion in chapters 2 and 3, numerous researchers have suggested that reincorporations occur when the corporation laws of the destination state are better suited to the firm's circumstances than the laws of the original jurisdiction. These theories would therefore suggest that reincorporations may also be motivated by a change in firm attributes. Perhaps the most convincing arguments in this regard are provided by Dodd and Leftwich (1980) and Romano (1985). Dodd and Leftwich (D&L) suggest that reincorporations commonly occur because of the anticipation of changes in corporate financing and investing activities. Similarly, Romano's transaction explanation of reincorporations suggests that reincorporations occur concurrently, or near the time of, specific corporate transactions. These transactions may involve either significant changes in ownership structure (such as an initial public offering), or other activities such as mergers and acquisitions that increase the need for a more flexible and more clearly defined corporate law.

While the current study provides evidence to support the contentions of D&L and Romano, there are few, if any, empirical tests that can be conducted to provide formal statistical support for their hypotheses. This is due to the wide variety of idiosyncratic contractual efficiency motives that do not lend themselves to statistical tests because they are not necessarily reflected in publicly available financial information. For instance, as evident in the sample collection statistics presented in the following chapter, the majority

charters. Specifically, the number of reincorporations usually increases immediately after a state offers some form of innovation in its corporate laws. The number of reincorporations tends then to decline slowly in the following years as other states adopt similar legislation. This pattern is also evident in the sample studied here.

of reincorporations are conducted preceding or surrounding an IPO. This finding is consistent with the arguments of both D&L and Romano. Further, the managers of many of the sampled firms explicitly state that the reincorporation is fundamental to future merger and acquisition activities and/or financing arrangements. This finding is also consistent with D&L and Romano's explanations. However, there is a great deal of variability in the form of these activities across firms and, to the extent that they are not manifest immediately as specific events, there are few if any empirical techniques that may be used to capture the relationships with firm attributes.

Baysinger and Butler (1985) however, offer an empirically testable explanation of reincorporations, suggesting that the firm's choice of strict vs. liberal jurisdiction is a function of the firm's residual claimants. Baysinger and Butler suggest that the corporate laws of strict states are better suited to firms with concentrated ownership. They contend that firms chartered in strict states will tend to stay in such jurisdictions until ownership becomes sufficiently dispersed that market governance becomes desirable. This implies that changes in those firm attributes that precipitate a change in corporate ownership structure may be the actual factors that lead managers to reincorporate out of a strict and into a more liberal jurisdiction.

The theory advanced by Baysinger and Butler yields predictions that are similar to the conjectures of Posner and Scott (1980). Posner and Scott suggest that the liberal corporation laws of jurisdictions such as Delaware are tailored to better meet the needs of large public corporations. To the extent that firm size and ownership structure are related, both of these theories imply that as firms grow in size and ownership concentration declines, firms will tend to migrate to jurisdictions with more liberal corporate laws.

Based on these conjectures, and those of D&L and Romano, one would expect to find that in general, firms that reincorporate for contractual efficiency reasons are growing firms with relatively concentrated ownership and that they exhibit characteristics consistent with a high demand for external financing. If this is indeed the case, it follows that such firms should be characterized by high growth opportunities (as proxied by market-to-book ratios, sales growth, etc.) and lower dividend payout rates. Over time, as external financing is obtained, inside ownership concentration will decline.

> **Hypothesis 3:** Firms that reincorporate to liberal states for non-defensive reasons other than tax or fee reduction reasons are in general, growth-oriented firms with concentrated ownership. These firms should exhibit characteristics consistent with a high demand for external financing.

> **Hypothesis 4:** Inside ownership concentration will decline subsequent to reincorporation into a more liberal jurisdiction.

Hypotheses 3 and 4 rely upon existing theories to develop predictions regarding the characteristics of those firms that migrate out of strict and into liberal jurisdictions for reasons consistent with contractual efficiency. However, some firms choose to leave liberal jurisdictions for reasons that are also consistent with contractual efficiency arguments. For example, many of the sampled firms chose to leave liberal states (primarily Delaware) in order to save on yearly franchise fees. As suggested by Posner and Scott and numerous others, the benefit's of Delaware's corporate laws and expert judicial system are greater for large publicly held firms with diffuse ownership structures.

In return, Delaware is able to extract a premium from these firms. However, for smaller firms with more concentrated ownership, such benefits may not be sufficiently large to justify significant annual chartering fees. Therefore, it may be more efficient for firms of this nature to incorporate in other jurisdictions with less imposing chartering fees.

> **<u>Hypothesis 5:</u>** Firms that reincorporate out of liberal jurisdictions such as Delaware in order to save on chartering fees are smaller firms with more concentrated ownership structures.

Finally, as will be further discussed in later chapters, over half of the sample firms cited director liability concerns as a primary factor in their decision to reincorporate. Through reincorporation, these firms were able to take advantage of corporate laws designed to counter the adverse effects of the mid-1980's crisis in the market for D&O liability insurance. While reincorporations for these reasons are consistent with contractual efficiency arguments, these firms are likely to exhibit characteristics that differ somewhat from the predictions of existing theories. Specifically, these firms should exhibit characteristics that increase their vulnerability to, and their likelihood of involvement in legal disputes with shareholders. Historically, at least two types of firms have been involved in disproportionately high levels of shareholder litigation: smaller, high-technology firms, and those firms that are performing poorly. High technology firms are frequently involved in shareholder litigation because of their volatile stock prices. Poorly performing firms are also frequently involved in shareholder litigation. Brook and Rao (1994) found that poorly performing firms react positively to the enactment of liability limitation provisions. They suggest that expert outside directors are valuable to poorly performing firms. Liability limitation provisions, by limiting the legal exposure of these decisionmakers, increase their willingness to serve on the boards of poorly performing firms.

> **<u>Hypothesis 6:</u>** Firms that reincorporate for director liability reasons are likely to exhibit characteristics that increase their vulnerability to shareholder disputes. These characteristics may include (i) conducting operations in high technology industries, or alternatively, (ii) poor managerial performance.

4.2.2 *Attributes of firms that reincorporate for antitakeover reasons*

The contractual efficiency theory and the managerial entrenchment theory differ primarily because the latter theory suggests that agency conflicts play an important role in the decision to reincorporate. However, existing research has neither hypothesized nor documented differences in firm attributes between 'efficient' relocations and relocations designed to entrench incumbent managers. The preceding section developed hypotheses, derived from existing theory, which imply that firms reincorporating for reasons consistent with contractual efficiency should exhibit specific traits. This section presents hypotheses which suggest that the attributes of firms reincorporating for reasons consistent with managerial entrenchment arguments will markedly differ from those for firms reincorporating for other purposes. These hypotheses are also empirically tested in chapter 9.

If managers of some firms use a reincorporation to a more liberal jurisdiction as a vehicle for entrenchment, it is anticipated that these firms will be characterized by higher levels of potential agency conflicts than the remainder of reincorporating firms. In addition, management is more likely to be responding to the possibility of future control contests resulting from poor performance. Therefore, it is predicted that these firms are likely to be characterized by lower growth opportunities (as proxied by market-to-book ratios, sales growth, etc.), higher levels of agency costs (as proxied by market-to-book ratios), poorer performance, and that they are more likely to be concentrated in lower growth industries (as proxied by dividend payout).

> **Hypothesis 7:** Firms that reincorporate for antitakeover reasons are characterized by lower growth opportunities, higher potential agency costs, and poorer performance.

In addition, these firms are more likely to be leaving comparatively 'strict' jurisdictions (those in which acceptable takeover defenses are not as effective) than are firms reincorporating for motives more consistent with contractual efficiency theories

4.3 Chapter summary

This chapter has used existing theories to develop hypotheses regarding how reincorporations should affect securityholders, and those factors that lead managers to make the decision to reincorporate. These hypotheses imply that both security price reactions and firm attributes will vary according the managerial motives. The hypotheses are further refined in Chapter 6, where the managerial motives for reincorporation are discussed in further detail.

CHAPTER 5

SAMPLE CONSTRUCTION AND SAMPLE STATISTICS

5.1 Sample construction

Firms included in the sample studied were identified using *Moody's Industrial Manuals*, *Moody's OTC Manuals,* and the *Disclosure Database*. These sources yielded an initial sample of 1004 firms that changed their state of legal residency during the period from 1980 to 1992. To remain in the sample, each firm was required to be listed on the *CRSP* tapes prior to the event. This requirement eliminated 448 firms. The majority of these firms were eliminated because the reincorporation was conducted prior to or surrounding the company's initial public offering. Details concerning the reincorporations of the remaining firms were gathered from proxy statements, prospectuses, 8K and 10K filings, and annual reports. 125 firms were eliminated at this point because of a lack of sufficient information on the stated motives and features of the reincorporation. Finally, firms which experienced significant additional events coinciding with the proposal to reincorporate were also excluded from the analysis. Examples of such events are the spin-off of a division (frequently the reincorporating division), acquisitions, and merger agreements. An additional 67 firms were eliminated due to these coincident events.

The resulting sample includes only those firms with data available on *Compustat*, *CRSP*, and with adequate information regarding the reincorporation proposal available in the firm's proxy statements to ascertain the motives for the reincorporation. The combination of the above requirements resulted in a final sample of 364 firms, as follows:

Figure 2 --Sample Evolution

Initial Sample	1004
Reincorporation preceding / surrounding IPO	448
Insufficient information	125
Significant coincident events	67
Final Sample	364

As shown in Figure 2, the majority of reincorporations either precede or coincide with an IPO. This is consistent with theories that imply the existence of significant relationships between size, ownership structure, and the choice of incorporation state. Unfortunately, due to the lack of pre-reincorporation financial information for these firms, they cannot be included in the empirical tests.

5.2 Statistics on the sample

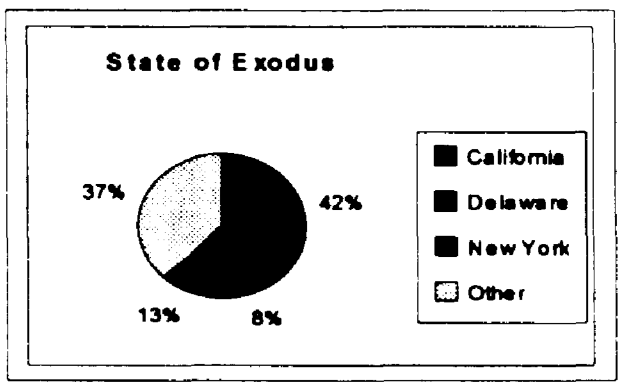
5.2.1 *Reincorporation statistics*

Prior research on reincorporating firms has concentrated mainly on NYSE listed firms. In contrast, the sample collected for the analysis here suggests that the majority of firms that reincorporated during the last decade were traded on the OTC market at the time of the event. For example, 224 of the 364 firms in the final sample (62%) were traded on the OTC market, while 56 firms (15%) were listed on the AMEX, and 84 firms (23%) were listed on the NYSE. The vast majority of firms (87%) reincorporated into Delaware. The latter figure is similar to those found by Dodd and Leftwich (1980) and

Romano (1985), who report the proportion of Delaware reincorporations in their samples as 90% and 82%, respectively.

Figure 3 provides a breakdown of the primary jurisdictions from which the firms reincorporated. As is evident in the Figure, a large portion of the firms that elected to change their legal jurisdiction during the study period relocated out of the strict states of California (42%) and New York (13%), while only 8% left Delaware. The state of California has long been considered to be a relatively strict jurisdiction, or "shareholder rights" state, due to its preponderance of laws to protect the interests of shareholders. The large proportion of firms choosing to leave California is indicative of the overall trend, where firms generally choose to reincorporate into a more liberal jurisdiction.

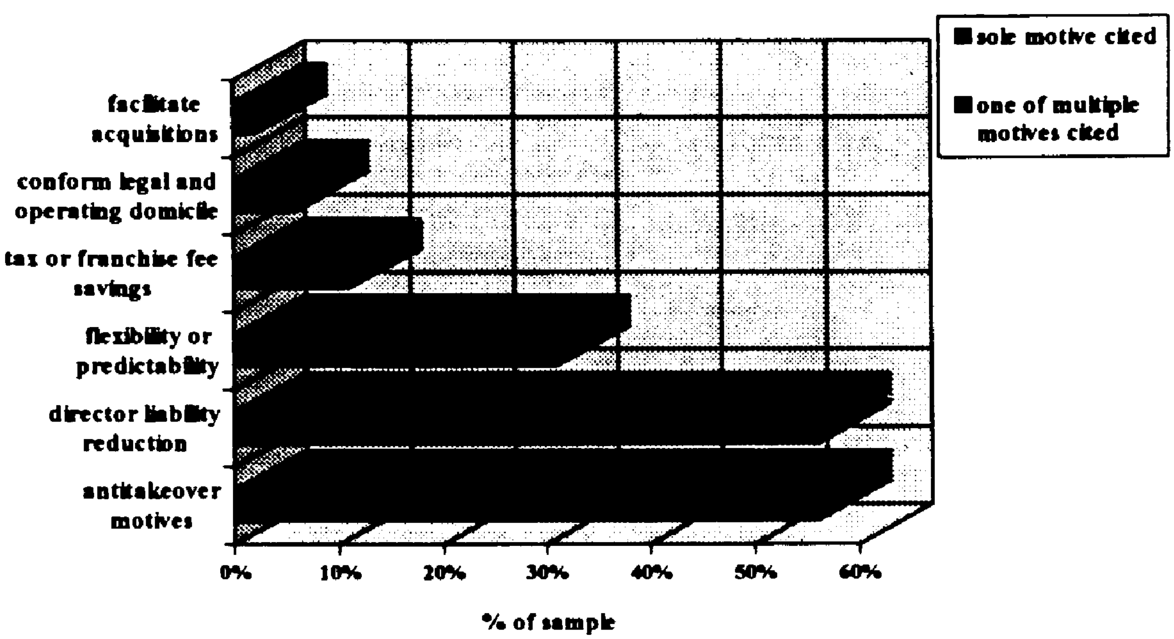
Figure 3



To gain some insight concerning the factors influencing the reincorporation decision, and to provide for better tests of the alternative hypotheses regarding the impact of the decisions, proxy statements were used to obtain the reasons offered by management as the motivations for the decisions. This proxy information for each firm was used to classify the stated motives into six categories. The categorizations include: (1) antitakeover purposes; (2) director liability reduction; (3) flexibility and predictability of corporate law; (4) tax and/or franchise fee savings; (5) conforming legal and operating domicile; and (6) facilitating future acquisitions.[20] The categorization of stated motives and their corresponding frequencies can be found in Figure 4. As evident in the Figure, the two dominant motives offered by management are antitakeover purposes and director liability reduction. However, managers also frequently cited multiple reasons for the decision to relocate. In the sample studied, the mean number of such stated motives was 1.6 and the median was 2. In those instances where multiple motives were offered, each motive is counted once in the construction of Figure 4.

Figure 4

Stated motives for reincorporation



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[20]Further information on the classification of stated motives is provided in Chapter 6.

Table 1 provides additional information regarding the nature of reincorporating firms by year. As is evident in the Table, the majority of reincorporations (52%) occurred during the years 1986 and 1987. These two years not only coincided with the peak of the takeover boom, but also represented the first two proxy "seasons" following:

(1) Significant court decisions upholding the legality of antitakeover defenses used by Delaware firms (specifically, the 1985 Delaware Supreme Court decisions in *Unocal vs. Mesa*, and *Moran vs. Household International*); and

(2) the adoption of changes in the Delaware General Corporation Law allowing firms to establish limitations on the liability of officers and directors of Delaware incorporated firms.

The significant decrease in the number of reincorporations after 1987 is attributable to two sources. First, the mass-migration to Delaware during 1986 and 1987 prompted many states to pass legislation similar to Delaware, allowing corporations to limit the legal liability of directors and to provide for greater indemnification of officers and directors.[21] Second, after the Supreme Court upheld the Indiana Control Share Acquisition Statute in *CTS Corp. vs. Dynamics Corp.* in 1987, many states quickly adopted similar third generation antitakeover statutes.[22] By 1988, at least 28 states provided statutory takeover protection. These developments increased the parity among state corporation laws on the two issues of primary concern to corporate managers. This trend is in support of Romano's suggestion that there exists a diffusion process in state corporation laws in

[21]According to Pamepinto (1988), by February of 1988, 33 states had amended their corporate statutes to permit limited director liability.

[22]*CTS Corp. vs. Dynamics Corp.*, 481 U.S. 69 (1987).

Table 1
Yearly reincorporation statistics

Asset and equity figures were taken from *Compustat* for the fiscal year of the reincorporation. The motives for the reincorporations were taken directly from the proxy statements proposing the move. The classifications of reincorporation motives presented in the final six columns are not mutually exclusive. Financial figures are stated in millions of dollars.

			Size		*Motives offered by management*					
Year	**N**	**% of sample**	**Mean assets**	**Mean equity**	**Anti-takeover**	**Liability reduction**	**Flexibility or predictability**	**Tax or fee reduction**	**Domicile reconciliation**	**Acquisition related**
1980	8	2.20%	116.60	104.61	5	0	6	2	1	0
1981	7	1.92%	437.66	115.81	0	0	4	3	1	1
1982	12	3.30%	208.62	120.40	5	0	7	3	1	1
1983	17	4.67%	758.70	484.57	14	0	7	0	0	1
1984	17	4.67%	456.59	277.67	11	1	10	2	2	0
1985	23	6.32%	1329.82	860.21	12	1	10	6	3	1
1986	54	14.84%	812.42	536.78	32	29	12	5	1	2
1987	136	37.36%	204.62	220.79	74	124	23	2	0	0
1988	30	8.24%	377.36	190.22	20	22	9	2	2	0
1989	24	6.59%	1623.85	840.55	13	14	11	4	3	0
1990	13	3.57%	174.97	249.45	9	6	6	4	2	0
1991	15	4.12%	316.13	236.28	8	5	7	4	1	0
1992	8	2.20%	319.20	197.22	2	2	3	3	2	0
Total	**364**	**100%**			205	204	115	40	19	6
		average	520.07	354.65						

which states are encouraged to follow the leader and adopt similar legislation in order to prevent firms from reincorporating out of their jurisdiction.

Table 2 provides the yearly migration patterns of the sample. Two trends are apparent from the Table. First, in the period from 1986 to 1988, which spans both the height of the 1980's takeover wave and the crisis in the market for D&O liability insurance, almost all reincorporations were to Delaware. The state of California was the primary loser during this period, as nearly 3/5 of all firms that reincorporated during 1987 chose to leave California. After California enacted its own legislation providing for limitations on director liability in September 1987, the proportion of the reincorporations from that state fell dramatically. Second, after 1988, the relative proportion of firms that either reincorporated out of Delaware, or moved to non-Delaware jurisdictions increased markedly. This follows a significant decline in the total number of reincorporations after the 1987 proxy season. These trends reflect an increased parity in post-1987 state corporation laws. In addition to illustrating a clear first-mover advantage for proactive states such as Delaware, the statistics in Table 2 also lend additional support for Romano's theory of a diffusion process in state corporation laws.

Table 3 contains a cross-tabulation of reincorporation motives according to chartering jurisdictions. The figures in the Table once again reflect the state of Delaware's preeminence in certain aspects of corporate law. In particular, Delaware stands out as the dominant destination state for corporations that are engaged in, or anticipate future involvement in, activities such as defensive maneuvering and/or an active merger and acquisition strategy, both of which heighten the probability of legal entanglements and

Table 2
Yearly migration patterns

The Table presents the migration patterns for the sample of reincorporating firms according to the year in which the reincorporation proposal was submitted to shareholders. The figures presented reflect both the absolute number of and the relative percentage of reincorporations per year classified according to the state of exodus and the destination state.

		State of exodus			*Destination state*	
Year	**N**	**California**	**Delaware**	**Other**	**Delaware**	**Non-Delaware**
1980	8	3	0	5	8	0
		37.50%	0.00%	6.25%	100.00%	0.00%
1981	7	0	3	4	3	4
		0.00%	42.86%	57.14%	42.86%	57.14%
1982	12	1	3	8	8	4
		8.33%	25.00%	66.67%	66.67%	33.33%
1983	17	7	0	10	16	1
		41.18%	0.00%	58.82%	94.12%	5.88%
1984	17	3	2	12	13	4
		17.65%	11.76%	70.59%	76.47%	23.53%
1985	23	7	3	13	18	5
		30.43%	13.04%	56.52%	78.26%	21.74%
1986	54	28	2	24	51	3
		51.85%	3.70%	44.44%	94.44%	5.56%
1987	136	77	2	57	133	3
		56.62%	1.47%	41.91%	97.79%	2.21%
1988	30	10	2	18	27	3
		33.33%	6.67%	60.00%	90.00%	10.00%
1989	24	6	3	15	18	6
		25.00%	12.50%	62.50%	75.00%	25.00%
1990	13	2	3	8	9	4
		15.38%	23.08%	61.54%	69.23%	31.77%
1991	15	6	3	6	9	6
		40.00%	20.00%	40.00%	60.00%	40.00%
1992	8	3	2	3	5	3
		37.50%	25.00%	37.50%	62.50%	37.50%
Totals	364	153	28	183	318	46
		42.03%	7.69%	50.27%	87.36%	12.64%

Table 3
Reincorporation motives according to exodus and destination states

The Table presents a cross-tabulation of reincorporation motives by chartering jurisdictions. The figures presented reflect both the frequency with which each motive was offered, by the state of exodus and the destination state

		State of exodus			*Destination state*	
Motive	**N**	**California**	**Delaware**	**Other**	**Delaware**	**Non-Delaware**
Antitakeover reasons	205	105 51.22%	8 3.90%	92 44.88%	191 93.17%	14 6.83%
D&O liability reduction	204	114 55.88%	0 0.00%	90 44.12%	200 98.04%	4 1.96%
Flexibility or predictability	115	22 19.13%	5 4.35%	88 76.52%	100 86.96%	15 13.04%
Tax or fee reduction	40	1 2.50%	23 51.50%	16 40.00%	12 30.00%	28 70.00%
Domicile reconciliation	19	1 5.26%	10 52.63%	8 42.11%	2 10.53%	17 89.47%
Facilitate acquisitions	6	1 16.67%	0 0.00%	5 83.33%	6 100.00%	0 0.00%

increase the need for supportive and predictable corporation laws. Furthermore, Delaware's actions with regard to limiting director liability make it the destination state of choice for these reasons as well, with over 98% of the reincorporations conducted with director liability concerns in mind being to Delaware.

Several trends are also apparent from the exit decisions of reincorporating firms. First, the historically strict state of California lost the majority of firms that reincorporated for antitakeover and director liability reduction reasons, while the majority of firms citing flexibility or predictability motives reincorporated from other non-Delaware jurisdictions. This implies that *ceteris paribus*, the shareholder watchdog philosophy inherent in California's corporate laws may subject managers of California-incorporated firms to higher risks relative to the corresponding exposure for similar firms incorporated in other jurisdictions. Second, Delaware is the primary state of exodus for those firms stating tax/fee reduction and domicile reconciliation motives. This is not unexpected, given the comparatively large annual chartering fees imposed by the state of Delaware on Delaware-incorporated firms and the relatively small industrial base of the state.

Table 4 presents the two-digit SIC classifications of the firms included in the sample. As apparent in the Table, the reincorporations occurred in a wide variety of industries. However, a large number are concentrated in high-growth industries such as computers and other high-technology areas. To test for industry concentration, a chi square statistic is computed for each industry (2-digit SIC) to determine if any industries exhibit a significantly greater concentration of reincorporating firms than would be expected by chance. The calculation of the expected number of firms for each industry is

Table 4
Standard Industrial Classification of reincorporating firms

Table 4 presents the primary SIC codes (at the two digit level) for the firms in the analysis. The concentration of reincorporating firms in the two digit SIC codes of 3500 and 3600 is significantly greater than expected at the 1% level (chi square statistics of 29.89 and 8.92). *, **, *** denote significance for chi-square statistics at the 10%, 5%, and 1% levels respectively.

Industrial classification	Code	N	Industrial classification	Code	N
Industrial, commercial mach., computer equip.	3500	51***	Communications	4800	6
Electrical equipment, excluding computers	3600	36***	Eating and drinking places	5800	6
Business services	7300	29	Motion pictures	7800	6
Instruments and related products	3800	27	Food and kindred products	2000	5
Chemicals and allied products	2800	21	Primary metal industries	3300	5
Oil and gas extraction	1300	13	Apparel and accessory stores	5600	5
Electrical, gas, and water utilities	4900	12	Depository institutions	6000	5
Transportation equipment	3700	10	Textile mill products	2200	4
Health services	8000	10	Paper and allied products	2600	4
Printing, publishing, and allied	2700	9	Stone, clay, glass, and concrete products	3200	4
Durable goods, wholesale	5000	9	Miscellaneous retail	5900	4
Rubber and misc. plastic products	3000	8	Metal mining	1000	3
Engineering, architect., management, & related	8700	8	Building construction - general contracting	1500	3
Furniture and fixtures	2500	7	Apparel and other finished products	2300	3
Fabricated metal, excluding mach. & trans.	3400	7	Nondepository credit institutions	6100	3
Nondurable goods, wholesale	5100	7	Insurance carriers	6300	3
other*		31			

* represents 24 classifications

a. Of those SIC classifications not represented in the Table, only the 2-digit SIC code of 6700 (Holding, or other investment offices) had a significantly lower frequency of reincorporations than expected (1% significance level).

based on the assumption that reincorporations are distributed across each industry in proportion to the population percentage of firms represented by that industry. To determine the benchmark proportions for each industry, the *Compustat* database was used. The results of the chi-square tests reveal that the concentration of reincorporations in the 2-digit SIC codes (3500's and 3600's) representing the high technology and electronic industries is significantly greater than expected at the 1% level (chi-square statistics of 29.89 and 8.92, respectively). As will be discussed later in the analysis, the majority of these technology-oriented firms moved to Delaware explicitly in search of liability protection for their board of directors.

5.2.2 *Attributes of the sampled firms*

Descriptive statistics on firm size and ownership characteristics are provided in Table 5. Total assets (book value) and market value of common equity figures are from *Compustat* for the fiscal year of the reincorporation. Information regarding ownership characteristics was collected from proxy statements and from *Standard and Poor's Security Owner's Stock Guides*. The proxy statements containing the reincorporation proposal provided the ownership position for all officers and directors and for all non-management blockholders owning 5 percent or more of the company's stock. Data on aggregate institutional shareholdings at the time of the reincorporation were obtained from the *Security Owner's Stock Guides*.

As is evident by a comparison of mean and median values for both assets and equity, the sample is dominated by a large number of smaller corporations. Firms in the

Table 5
Size and ownership characteristics

Table 5 presents size and ownership characteristics for the sampled firms. Panel A reports the information for the entire sample and for each classification of motives. Panel B presents the corresponding information for those firms that mentioned a single motive for the reincorporation. Asset and equity values were taken from *Compustat*. Officer and director ownership and the ownership of significant (>5%) non-management blockholders (non-institutional) were taken from proxy statements. Institutional ownership figures were taken from *Standard and Poor's, Security Owner's Stock Guides*.

Panel A

ALL CATEGORIES		Entire sample	Antitakeover motives	Director liability motives	Flexibility or predictability motives	Tax/Fee motives	Domicile reconciliation motives	Acquisition related motives
N		364	205	204	115	40	19	6
Total assets (millions)	mean	520.078	733.702	214.216	853.393	160.033	375.020	1545.545
	median	71.185	79.680	55.785	75.980	69.795	75.616	856.696
MV equity (millions)	mean	354.654	503.677	208.838	374.920	147.550	444.604	1006.627
	median	54.710	63.010	44.355	54.530	48.560	100.047	560.777
Ownership of officers and directors	mean	26.46%	25.28%	26.91%	26.81%	32.14%	34.08%	15.86%
	median	23.30%	22.80%	24.09%	22.27%	33.22%	30.96%	9.42%
Non-management blockholder ownership	mean	7.90%	8.37%	8.63%	7.33%	7.47%	7.08%	2.16%
	median	5.12%	5.40%	5.70%	0.00%	5.80%	0.00%	0.00%
Institutional ownership	mean	21.54%	23.92%	22.53%	18.08%	15.71%	18.38%	31.52%
	median	18.19%	20.90%	19.04%	12.40%	12.29%	18.23%	31.22%
Exchange listing at reincorporation								
OTC		224	116	144	66	26	10	2
AMEX		56	31	33	17	5	3	1
NYSE		84	58	27	32	9	6	3

Panel B

EXCLUSIVE CATEGORIES		Antitakeover motives	Director liability motives	Flexibility or predictability motives	Tax/Fee motives	Domicile reconciliation motives
N		49	68	30	15	2
Total Assets (millions)	mean	1027.780	162.710	329.560	150.350	435.500
	median	133.630	55.205	51.630	85.890	435.500
MV Equity (millions)	mean	890.510	138.157	124.930	152.670	129.540
	median	95.220	45.965	35.185	35.190	129.540
Ownership of Officers and Directors	mean	22.13%	25.41%	27.71%	36.71%	14.93%
	median	17.73%	22.45%	20.97%	40.00%	14.93%
Non-management blockholder ownership	mean	7.05%	10.05%	7.31%	5.76%	12.34%
	median	0.00%	5.17%	2.70%	0.00%	12.34%
Institutional ownership	mean	25.42%	23.46%	12.85%	12.55%	28.06%
	median	25.33%	18.96%	5.86%	9.77%	28.06%
Exchange listing at reincorporation						
OTC		19	51	21	7	0
AMEX		9	10	4	3	1
NYSE		21	7	5	5	1

director liability and tax/fee classifications are generally smaller in size than firms in the other classifications. In contrast, firms stating future acquisitions as a motive for reincorporation appear to be substantially larger than firms in the remaining classifications.

An additional firm characteristic that has been hypothesized to influence both the reincorporation decision and the governance of the firm is ownership concentration. Table 5 presents both the mean and median ownership positions of officers and directors (insiders), substantial non-management non-institutional blockholders, and institutional investors. The mean (median) ownership position of officers and directors in the sample is 26% (23%), indicating a relatively high level of managerial ownership.[23] This high level of insider ownership suggests that in many cases, shareholder approval of the reincorporation proposal is virtually assured, since managerial ownership represents a substantial portion of the voting shares. In fact, managers control in excess of 50% of the outstanding voting rights in 16% of the sample. The mean ownership of substantial (>5%) non-management non-institutional blockholders is approximately 8%, with a median slightly over 5%. Slightly over half of the sampled firms (51%) have at least one significant non-management blockholder. Finally, the mean (median) ownership of institutional investors is 22% (18%).

[23] As a comparison, Morck, Shleifer, and Vishny (1988) report board of director ownership figures of 10.6% (mean) and 3.4% (median) for their sample of 371 Fortune 500 firms. Brickley, Lease, and Smith (1988) report similar officer and director holdings of 10.1% (mean) and 4.4% (median) for their sample of 191 firms proposing antitakeover amendments in 1984.

Table 5 also presents figures reflecting the exchanges on which the sample firms were traded as of the time of reincorporation With the exception of those firms that cited either acquisition related motives or solely antitakeover motives, the majority of reincorporating firms were traded on the OTC market. This sample attribute differs somewhat from past research, in that past research on reincorporations has focused primarily on NYSE and AMEX firms, even though the vast majority of reincorporating firms are not in fact listed on those exchanges.

5.3 Chapter summary – sample statistics

The sample constructed for this study reveals several trends in the reincorporations of firms since 1980. These trends are discussed in the following paragraphs.

As was shown in Figure 2, the majority of reincorporations occurred prior to when firms become publicly traded. While the lack of financial data for these firms prevents their inclusion in empirical tests, the frequency of these reincorporations lends support to existing theories suggesting that firms will move to more liberal jurisdictions such as Delaware when they become sufficiently large and ownership concentration becomes dispersed enough that liberal corporation laws improve contractual efficiency.

Second, the majority of publicly traded firms that reincorporated were relatively small firms with concentrated ownership. Over 3/5 of those firms (62%) were traded on the OTC exchange at the time of their reincorporation. The majority of these firms migrated out of strict, and into liberal jurisdictions (e.g. 55% left the strict states of California and New York, while 87% relocated into Delaware). The most frequently cited motives for these reincorporations were antitakeover measures and director liability reduction. While the migration patterns and dominant reincorporation motives are not inconsistent with managerial entrenchment arguments, they may also imply that the corporate laws of comparatively strict jurisdictions may result in excessively high levels of risk exposure for the managers of firms chartered in such jurisdictions. This exposure may arise out of several sources, ranging from shareholder lawsuits to the threat of job loss via corporate takeover.

Finally, the trend in the frequency of reincorporations over time (as shown in Table 2) provides support for the theory that the competition in the market for corporate charters creates a diffusion process in state corporation laws. The state of Delaware received a windfall of reincorporations in the years of 1986 and 1987 primarily because it was the first state to provide corporate managers with the option of adopting charter amendments to limit the liability of corporate directors. As other states followed the leader and offered similar provisions in their corporate laws, the number of reincorporations per year declined substantially.

CHAPTER 6

REINCORPORATION MOTIVES

This chapter examines the most prevalent managerial motives for reincorporation during the sampled period. The classification of reincorporation motives is fundamental to the analysis since there exists a wide variety of potential reasons why corporate managers would choose to change the firm's chartering jurisdiction and, therefore, a wide degree of heterogeneity in the overall population of reincorporating firms. The combining of those reincorporations with similar express and implied managerial motives not only serves to focus attention on each of the different reasons why managers may deem a change in the corporate environment as desirable, but also provides for clearer tests of the alternative hypotheses presented in chapter 4.

Additional evidence corroborates the notion that an analysis of reincorporations should place emphasis on managerial motives. For example, the responses to the IRRC's 1990 survey of institutional investors reveal that, among the governance-related activities followed by the IRRC, reincorporations are second only to restructuring proposals in the frequency with which they are explicitly evaluated by institutional investment managers. Specifically, 76% of the respondents representing institutional investors indicated that their policy was to evaluate and determine their support or opposition to reincorporation proposals on a case-by-case basis. Only 15% responded that their standard policy was to vote in support of a change in legal jurisdiction, while 9% of the surveyed institutions stated a standard policy of opposing reincorporation proposals. To the extent that institutional investors promote shareholder interests, the voting policies of institutional investors illustrate the important relationships between reincorporation motives and those interests.

Section 6.1 presents information on how the individual reincorporation proposals were classified according to managerial motives. For each classification, a brief excerpt from a proposal of that type is provided to familiarize the reader with how managers attempt to solicit shareholder support for the move. Section 6.2 provides a further discussion of these motives. This discussion includes a substantial amount of background information in order to allow the reader to gain a greater understanding of the conditions that precipitate the reincorporation. In addition, as specific motives are addressed in section 6.2, their consistency with the general hypotheses presented in chapter 4 is addressed. Those hypotheses are developed further in the process.

6.1 Method of classification

Within the proxy statement containing the reincorporation proposal, managers usually provide shareholders with a fairly in-depth explanation of the differences between the corporate laws in the current and prospective states of incorporation, as well as the reasons why management proposes the move. To be included in the sample, firms were required to provide this information in enough detail to allow a clear determination of the managerial motives for the reincorporation.

After reading all of the 364 proxy statements and documenting the motives offered by management in each case, 6 fairly distinct classifications of motives emerged. These classifications are used in the analysis. Note that these categories of motives are not mutually exclusive. Management frequently provided multiple reasons for the decision to reincorporate. Figure 5 provides a list of the major categories ranked according to the frequency of their occurrence (N). The Figure also provides the number of times that each motive was offered exclusively (N2).

Figure 5 -- Motive frequencies

	Motives offered by management	**N**	**N2 (offered exclusively)**
1)	Antitakeover	205	49
2)	Director liability reduction	204	68
3)	Flexibility or predictability of corporate law	115	30
4)	Tax or fee reduction	40	15
5)	Domicile reconciliation	19	2
6)	Facilitate future acquisitions	6	0

For the majority of the sampled firms, the proxy statements contained a section citing management's motives for the reincorporation. This information is generally presented in a section of the proxy statement titled "Principal reasons for the reincorporation." In these cases, the identification of managerial motives for the reincorporation decision was rather straightforward. However, it was often the case that the reincorporation would result in significant changes in shareholder rights that were not specifically addressed in management's explanation of why they had proposed the reincorporation. Frequently, the reincorporation proposals contained "hidden amendments," resulting in significant changes in shareholder rights, such as the elimination of cumulative voting procedures and the classification of directors. Since hidden amendments of this nature improve management's ability to fend off hostile acquirers and limit the influence of large blockholders, they can have an antitakeover effect. In most cases, the only way to identify these hidden amendments was to look for differences between the corporate charters and bylaws in the state of exodus and the destination state.

The remainder of this section provides a more in-depth explanation of each classification of motives used in the analysis. Motives are presented in an order according to the frequency of their occurrence. A brief example is also provided for each.

6.1.1 *Antitakeover motives*

Firms were placed in this category if managers explicitly mentioned that the reincorporation would enable management to take advantage of state corporation laws and adopt charter provisions intended to make it more difficult to obtain control of the company through transactions not having board approval. Due to the presence of hidden amendments having antitakeover effects, the classification of firms in this category was somewhat more subjective than for the remaining categories. In a few instances, firms were included in this category even though management did not expressly mention antitakeover motives as an important factor in their decision to reincorporate. In these cases, the resulting classification depended upon the number of hidden amendments, and the potential for such amendments to entrench management. As a general rule, those reincorporations in which managers did not expressly mention antitakeover motives, but included more than one charter amendment having a potential antitakeover effect were classified as having implied antitakeover motives.

The following excerpt from the proxy statement of the Union Oil Company of California (Unocal), dated March 28, 1983, provides an example of a typical proposal by management to reincorporate for antitakeover reasons. Unocal reincorporated from California to Delaware.

> "In addition, incorporation of the proposed holding company under the laws of Delaware will provide an opportunity for inclusion in its certificate of incorporation provisions to discourage efforts to acquire control of Unocal in transactions not approved by its Board of Directors, and for the elimination of shareholder's preemptive rights and the elimination of cumulative voting in the election of directors.
>
> The proposed changes do not result from any present knowledge on the part of the Board of Directors of any proposed tender offer or other attempt to change the control of the Company, and no tender offer or other type of shift of control is presently pending or has occurred within the past two years.
>
> Management believes that attempts to acquire control of corporations such as the Company without approval by the Board may be unfair and/or disadvantageous to the corporation and its shareholders. In management's opinion, disadvantages may include the following:
>
> - a non-negotiated takeover bid may be timed to take advantage of temporarily depressed stock prices.
>
> - a non-negotiated takeover bid may be designed to foreclose or minimize the possibility of more favorable competing bids.
>
> - recent non-negotiated takeover bids have often involved so-called "two-tier" pricing, in which cash is offered for a controlling interest in a company and the remaining shares are acquired in exchange for securities of lesser value.

> Management believes that "two-tier" pricing tends to stampede shareholders into making hasty decisions an can be seriously unfair to those shareholders whose shares are not purchased in the first stage of the acquisition.
>
> - non-negotiated takeover bids may involve the acquisition of only a controlling interest in the corporation's stock, without affording all shareholders the opportunity to sell on the same terms.
>
> - non-negotiated takeover bids are most frequently fully taxable to shareholders of the acquired corporation.
>
> By contrast, in a transaction subject to approval of the Board of Directors, the Board can and should take account of the underlying and long-term value of assets, the possibilities for alternative transactions on more favorable terms, possible advantages from a tax-free reorganization, anticipated favorable developments in the Company's business not yet reflected in stock prices, and equality of treatment for all shareholders.
>
> Accordingly, provisions have been included in the Certificate of Incorporation of Unocal intended to make it more difficult to acquire control through transactions not having the approval of the Board of Directors. Nothing in the proposed reorganization would prevent any third party from making a tender offer to Unocal's shareholders to offer to buy Unocal's shares or prevent any shareholder from accepting such an offer."

The reincorporation of Unocal allowed management to add several antitakeover provisions to Unocal-Delaware's corporate charter that were not available under the corporate laws of California. These provisions, which were bundled as a part of the reincorporation plan, included: the establishment of a classified board, the elimination of cumulative voting, and a supermajority voting requirement for any reorganizations or business combinations not approved by 75% of the directors then in office.

Two years after its move to Delaware, Unocal was the beneficiary of a favorable court ruling in the *Unocal vs. Mesa* case, in which the Delaware Court upheld Unocal's discriminatory repurchase plan as an appropriate response to the Mesa Petroleum's hostile takeover attempt.

6.1.2 *Director liability reduction*

Firms included in this category specifically mentioned that a primary motive for the reincorporation was to take advantage of state corporation laws that allowed the firm to adopt charter amendments to limit director liability and/or enter into indemnification agreements with officers and directors. The majority of these firms moved to Delaware to take advantage of Delaware legislation, effective July 1, 1986, that authorized Delaware-incorporated firms to include a provision in their certificate of incorporation eliminating the personal monetary liability of directors to the corporation or its stockholders arising out of a breach of fiduciary duties. Many of these firms also entered into indemnification agreements, which provide that the corporation will pay all of the expenses resulting from a lawsuit against the firm's officers or directors.

The following excerpt from the proxy statement of the Optical Coatings Laboratories (February 19, 1987), provides an example of a proposal by management to reincorporate for director liability reduction reasons and illustrates the magnitude of the impact of the D&O insurance crisis on D&O liability insurance premiums. Optical Coating Laboratories reincorporated from California to Delaware.

> "During 1986, the Company's annual premium for its directors' and officers' liability insurance was increased from $17,500 to $250,000 while the coverage was reduced from $50,000,000 to $5,000,000 in spite of the Company's impeccable record of never having had a claim. This is a result of the so-called directors' and officers' liability insurance crisis which has caused many corporations to lose coverage altogether and forced many

directors to resign rather than risk financial ruin as a result of their good faith actions taken on behalf of their corporations.

This year at OCLI, we intend to do something about this problem. You will see included in the proxy materials a proposal to amend the Company's Articles of Incorporation, if California enacts the necessary legislation, to provide the Company's officers and directors with significantly greater protection from personal liability for their good faith actions on behalf of the Company. If California does not enact the necessary legislation by the date of the annual meeting, or any adjournment, a different proposal would provide for the Company to change its legal domicile to the State of Delaware, where the corporation law was recently amended to provide for such protection. No other change is being made in the Company's Articles of Incorporation."

6.1.3 *Flexibility or predictability of corporate law*

The flexibility/predictability classification encompasses a broader set of firms than the other classifications. Many of the firms offering this motive indicated that one of main reasons for the reincorporation was that the move would provide the firm with increased flexibility in the corporation's capital structure, enabling the firm to take full advantage of future investment opportunities. Alternatively, many firms mentioned their desire to governed by the predictable corporate laws of a jurisdiction with well established corporation laws and court precedents.

The following excerpt from the proxy statement of Computercraft (July 30,1984), provides an example of a typical proposal by management to reincorporate in order to take advantage of flexible and predictable corporate laws. Computercraft reincorporated from Texas to Delaware.

"The Board of Directors believes that the best interests of the Company and its shareholders will be served by changing its place of incorporation from the State of Texas to the State of Delaware. The Company was incorporated in the State of Texas in November 1977 because the laws of

> that state where deemed to be adequate for the conduct of its business. The Board of Directors believes that there is needed a greater flexibility in conducting the affairs of the Company since it became a publicly owned company in 1983.
>
> The General Corporation Law of the State of Delaware affords a flexible and modern basis for a corporation action, and because a large number of corporations are incorporated in that state, there is a substantial body of case law, decided by a judiciary of corporate specialists, interpreting and applying the Delaware statutes. For the foregoing reasons, the Board of Directors believes that the activities of the Company can be carried on to better advantage if the Company is able to operate under the favorable corporate climate offered by the laws of the State of Delaware."

6.1.4 *Tax or fee reduction*

Forty firms specifically mentioned that a primary motive for reincorporation was to lower the franchise taxes and fees imposed on the firm by the firm's current chartering state and in many cases by the state in which the company conducted the majority of its business. The following excerpt from the proxy statement of AutoZone (November 15, 1991) provides an example of a reincorporation conducted for these reasons. AutoZone reincorporated from Delaware to Nevada.

> "The primary reasons for reincorporating in Nevada are (i) to allow the Company to claim a reduction in Texas franchise taxes of approximately $1.3 million imposed on 1991 fiscal year net income and (ii) to eliminate Delaware franchise taxes of approximately $150,000 per year in succeeding fiscal years.
>
> Pursuant to recent amendments to the Texas franchise tax statutes, a corporation which was subject to the Texas franchise tax in 1991 will be assessed a Texas franchise tax on its 1991 federal taxable income, after certain adjustments and modification, if it continues to conduct business in Texas in 1992. The Company currently has operations in 20 states, including Texas, where the Company operates 130 auto parts stores. If the Merger is not implemented, the Company will be assessed franchise tax based on its 1991 federal taxable income. Upon completion of the Merger prior to 1992, it is the Company's intention that AutoZone Nevada would

> claim that no Texas franchise tax can be imposed on the Company's 1991 net income since the separate corporate existence of the Company will have ceased. On November 19, 1991, the Texas Comptroller of Public Accounts issued a proposed transition rule that would eliminate the Texas franchise tax benefit which AutoZone Nevada intends to claim as a result of the Merger. The Company cannot predict whether the Proposed Rule will be adopted and, if so, whether it will be determined by a court to be a valid exercise of the Texas Comptroller's rule-making authority. Accordingly, there can be no assurance that the anticipated tax savings will ultimately be realized.
>
> In addition, the cost of being incorporated in Nevada will be substantially less than the cost of being incorporated in Delaware. The State of Delaware bases its franchise fees on the number of authorized shares of a company's stock, subject to a maximum fee of $150,000. For the 1991 calendar year, the Company will pay approximately $110,000 in annual franchise fees to the State of Delaware and anticipates paying the maximum $150,000 in future years. The State of Nevada, however, charges a flat filing fee of $85 per year, regardless of the number of authorized shares. Thus, the Merger will result in annual cost savings of approximately $150,000 in franchise fees."

6.1.5 *Domicile reconciliation*

The management of 19 firms suggested that domicile reconciliation was a primary factor in the decision to reincorporate. This motive was offered exclusively for only 2 of the sampled firms. The remaining firms that cited this motive cited additional motives, such as tax or fee savings. The following excerpt from the proxy statement of the Longview Fibre Company (December 13, 1989) provides an example of a reincorporation conducted in part for these reasons. The Longview Fibre Company reincorporated from Delaware to Washington.

> "Through the Change in Domicile, the Company intends to further its identification with the state in which the Company's business originated, it principal business is conducted and over 64% of its employees are located. Since the Company's incorporation in the State of Delaware in 1926, the laws of the State of Washington have developed into a system of

comprehensive and flexible corporate laws that are currently more responsive to the needs of businesses in the state.

After considering the advantages and disadvantages of the proposed Change in Domicile, the Board of Directors concluded that the benefits of moving to Washington outweighed the benefits and detriments of remaining in Delaware, including the continuing expense of Delaware's annual franchise tax (the Company paid $56,000 in franchise taxes in fiscal year 1988, whereas the "annual renewal fee" for all Washington corporations is $50.00). In light of these facts, the Board of Directors believes it is in the best interests of the Company and its stockholders to change its domicile from Delaware to Washington."

6.1.6 *Facilitate acquisitions*

The management of 6 firms mentioned that the reincorporation would facilitate the company's strategy of growth through acquisitions. However, no firm cited this motive as the sole reason for the reincorporation. The following excerpt from the proxy statement of The Limited Stores, Inc. (April 19, 1982) provides an example of management's proposal to reincorporate for these reasons. The Limited Stores, Inc. reincorporated from Ohio to Delaware.

"The proposed new structure, in which The Limited, Inc. becomes the publicly-owned company and Old Limited and various subsidiaries of Old Limited become subsidiaries of The Limited, Inc., is also expected to facilitate growth by providing greater flexibility in making acquisitions and other investments and permitting the enterprise to take better advantage of favorable business opportunities. Old Limited has participated from time to time in negotiations for the acquisition of other retail or apparel businesses. However, no assurance can be given that any such acquisition or any other such acquisition will or will not be effected."

6.2 Discussion of the reincorporation motives provided by management

As is evident in section 6.1 and in Figure 4, management frequently offers a variety of motives as the impetus for changing the firm's state of incorporation. Presumably, investors use this information to formulate a more accurate assessment of the decision's impact on the firm's future prospects. In addition to providing background information where appropriate, the following discussion considers a variety of possible interpretations of each category of reincorporation motives and develops corresponding hypotheses regarding the associated firm attributes and the impact on shareholder wealth.

6.2.1 *Antitakeover motives*

The issue of antitakeover measures and shareholder wealth has been extensively examined in the corporate finance literature during the last decade in response to the increased use of takeover defenses by managers to protect themselves from an active market for corporate control. A review of this literature is provided in chapter 3.

The literature proposes two primary motives for the implementation of takeover defenses that lead to different hypotheses regarding firm value. One hypothesis, often referred to as the "shareholder interests hypothesis," suggests that antitakeover measures should have a positive impact on firm value since they provide management with increased bargaining power in the event of a takeover attempt. That increase in bargaining power presumably allows management to fend off inadequate proposals and to negotiate for higher premiums in takeover attempts that succeed. Proponents of this viewpoint argue that antitakeover measures meeting this criteria will be in the best interests of shareholders. Alternatively, a second hypothesis, commonly referred to as either the "stockholder exploitation hypothesis," or the "managerial entrenchment hypothesis," suggests that antitakeover measures will have a negative impact on firm value since they serve to entrench poorly performing management. According to this hypothesis, antitakeover measures impose additional costs on a potential acquirer to the extent that any shareholder gains attributable to increased managerial bargaining power are more than offset by the reduced probability that the firm will be acquired. Therefore, the net effect of such measures is a reduction in firm value due to constraints on the market for corporate control.

Empirical research conducted to test these hypotheses has produced conflicting results, depending on the type of defense and the time frame of the analysis. Comparison of the results of early analyses and their later counterparts, however, suggests that the wealth effects of both firm-level takeover defenses and state takeover legislation have become increasingly negative over time.[24]

Evidence here of a negative stock market reaction to reincorporations undertaken to implement antitakeover measures would be consistent with arguments that managers

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[24]Early studies such as DeAngelo and Rice (1983) and Linn and McConnell (1983) found no statistical support for arguments that antitakeover amendments negatively impact security prices and thus no empirical support for the managerial entrenchment hypothesis. In contrast, research conducted on takeover defenses implemented during the latter half of the 1980's (mainly since the advent of second-generation takeover defenses) has found that in general, antitakeover measures negatively impact shareholder wealth [e.g., Jarrell and Poulsen (1987), Malatesta and Walkling (1988), Ryngaert (1988), Karpoff and Malatesta (1989), and Mahoney and Mahoney (1993)]. The results of the later studies are consistent with managerial entrenchment arguments.

use reincorporations as an entrenchment technique. However, compelling arguments can also be made that security price reactions for this set of firms should be non-negative, or even positive. This would be the case if the benefits from the reincorporation were perceived to dominate the negative effects of the takeover barriers to be erected. Such benefits could arise out of other differences between the corporate laws in the state of exodus and the destination state. Possible benefits include, but are not limited to: improved takeover bargaining power, lower contracting costs (e.g., lower insurance premiums), increased flexibility in financing activities, lower taxes or chartering fees, and the increased predictability of corporate law. An additional argument can be made that a reincorporation to establish stronger takeover defenses may signal to investors that the firm is a likely takeover target, and that existing defenses are not sufficient to thwart a serious takeover attempt. Such a signal is likely to have a positive effect on market valuation.

In addition to these primary arguments, it is possible that certain firm level characteristics may have a significant impact on the market's reaction to a firm's efforts to reincorporate for antitakeover reasons. A few examples of such characteristics include ownership structure, historical performance, the industry in which the firm does business, and whether or not the company is "in play".

Jarrell and Poulsen (1987) document a negative relationship between the level of insider ownership and share price reactions to takeover defenses. They suggest that this relationship reflects the fact that high inside ownership levels make it possible for management to pass more harmful charter amendments than is possible for firms with lower levels of managerial ownership and higher levels of institutional holdings. The presence of a large blockholder may also have a significant impact on the reaction to the decision. Shleifer and Vishny (1986) suggest that large, non-management affiliated blockholders have the incentive to actively monitor management, and when necessary, can facilitate changes in corporate control. Defensive maneuvering is often a direct response to the accumulation of a large equity position in the company, and is likely to be specifically designed to undermine the ability of such a securityholder to influence managerial policies. As a result, large non-affiliated blockholders are likely to oppose such proposals. If this is the case, one would expect to find an inverse relationship between the level of substantial non-management equity positions and the market reaction to the decision.

Firm performance may also influence the reaction to management's reincorporation decision, to the extent that performance reflects the quality of managerial decision-making. Manne (1965) suggests that an active takeover market is necessary to replace managers of poorly-performing firms, and that the likelihood of such a disciplinary control contest is increasing in the level of underperformance. A positive relationship between measures of firm performance and share price reactions to reincorporations (i.e., shareholders of poorly-performing firms should be more adversely effected by constraints on the market for corporate control) would support arguments in the literature suggesting that managers of poorly-performing firms establish takeover defenses as a mechanism to achieve job preservation.

In accordance with Stein's (1988) managerial myopia hypothesis, it is likely that the nature of a firm's operations is correlated both with the probability that managers propose takeover defenses and the benefits of the defensive measures. Stein argues that takeover defenses may be desirable to the shareholders of firms engaged in activities with long-term payoffs. The crux of Stein's hypothesis is that capital markets systematically undervalue the payoffs associated with long-term projects in favor of the more easily quantifiable cash flows of shorter-term projects. If so, managers without sufficient protection from the ill effects of this myopia-induced undervaluation (i.e., thereby subject to unwarranted control contests) are forced to respond by adopting a shorter-term orientation, favoring near-term projects at the expense of better longer-term ones. Stein argues that shareholders benefit from takeover defenses to the extent that they insulate management against such control contests, and allow managers to place the required emphasis on long-term decision-making.

Stein's hypothesis implies that *ceteris paribus*, firms conducting operations in industries prone to be adversely impacted by myopic capital markets are likely to benefit to a greater extent from takeover protection. While it is difficult to test these propositions empirically at the industry level, it is possible to proxy for such characteristics at the firm level using measures of long-term capital investment such as capital expenditures and research and development (R&D) expenses. In light of Stein's hypothesis, one would expect to find a positive relationship between the relative level of capital investment and R&D spending and the share price reactions to reincorporations conducted for defensive purposes. Furthermore, Stein's hypothesis implies that the managers of firms with proportionately high levels of capital expenditures and R&D investment will be more likely to propose antitakeover measures to counter the ill effects of market myopia.

An additional characteristic that may play a significant role in both the decision by management to reincorporate for antitakeover reasons, and in the market's reaction to the decision, is whether or not the firm is considered to be "in play." Firms are characterized as in play if they are the subject of a recent or ongoing takeover attempt or if reports in the business press identify the firm to be a possible takeover candidate. Given that the shareholders of these firms have a heightened probability of receiving takeover premiums, the market's reaction to management's defensive maneuvering is likely to more accurately distinguish between the competing hypotheses. A negative relationship between in play status and the share price reactions to defensive reincorporations would suggest that the benefits of management's increased bargaining power are more than offset by the reduced probability that shareholders will receive takeover-related premiums. Such a result would be consistent with the existing evidence that some states provide managers with too much takeover protection and would suggest that managers facing control threats take advantage of the differences between state corporation laws by reincorporating to jurisdictions that provide them with the means to entrench themselves.

The preceding discussion provides the motivation for cross-sectional analysis, suggesting that several firm-level characteristics may play an influential role in both management's decision to reincorporate for defensive measures and in how securityholders react to the decision. A combination of logistic regressions and a cross-sectional analysis of abnormal returns are used to test these relationships.

6.2.2 *Director liability reduction motives*

As noted earlier, changes in the corporate environment since 1980 involving increased shareholder activism and the proliferation of control contests have increased managerial exposure to shareholder scrutiny. The level of scrutiny was greatly intensified as a result of the Delaware Supreme Court's ruling in the 1985 *Smith vs. Van Gorkom* case.[25] Prior to *Smith vs. Van Gorkom*, the Delaware Court had demonstrated its unwillingness to use the benefit of hindsight to question the decision-making of corporate directors. Instead, the court provided corporate decision-makers protection under the "business judgment" rule, as long as it was apparent that directors had acted in good faith and had not violated their fiduciary duties to shareholders. However, in *Smith vs. Van Gorkom*, the Delaware court held that the directors of Trans-Union breached their duty of care by approving a merger agreement without sufficient deliberation, despite the fact that the terms of the agreement were to sell the company at a substantial premium.[26] A ruling of this nature was unexpected and, as a result, had an immediate impact on the corporate community. First, the decision revealed to shareholders the willingness of the Courts to entertain the possibility of monetary damages against directors in cases where such

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[25] *Smith vs. Van Gorkom* 488 A.2d 858 (Del. 1985).

[26] While the agreement was to sell the company at a 50% premium over its current market value, the Delaware Supreme Court sided with the plaintiff due to the apparent lack of sufficient deliberation on the part of the directors. The Court held that the directors demonstrated negligence since they hastily approved the merger agreement presented by Chairman Jerome Van Gorkom in just two hours, without soliciting advice from investment bankers. The case was settled for $23.5 million, exceeding Trans Union's D&O insurance policy limit of $10 million.

damages were previously not thought to be possible. This undoubtedly contributed to the substantial increase in shareholder lawsuits thereafter.[27] Second, the increase in exposure led to an immediate escalation in D&O liability insurance premiums that made the need to provide officers and directors with sufficient liability protection a much more costly proposition.[28] This problem is likely to be more pronounced for small high-technology firms whose wide swings in security prices, may especially prompt shareholder legal action.

In response, many jurisdictions such as Delaware established provisions in their corporate law allowing a firm to enter into indemnification agreements and limit the personal liability of the firm's officers and directors.[29] Consequently, corporations quickly took advantage of such provisions. In fact, as is evident in the sample, many firms elected

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[27]Between 1979 and 1987, the number of director and officer liability suits grew at an annualized rate of 25% per year. During this period, the largest annual increase in reported claims occurred in 1985 (the year of the Delaware Court decision in ***Smith vs. Van Gorkom***). During 1985, the frequency of reported claims increased by 34% over the corresponding level reported for 1984 (The Wyatt Company, 1988). [I am indebted to Phil Norton and Mary Maze of the Wyatt Company for providing me with these figures.]

[28] An index used to track average D&O insurance premium costs exhibited a 12-fold increase in the 3 year period from 1984 to 1987. At the same time, policy limits were dropping and exclusions were expanded to include the more risky aspects of corporate decision-making, such as asset sales and merger agreements (The Wyatt Company, 1988). It should also be pointed out that the index is likely to represent only those firms that were *still able* to obtain D&O insurance. According to the proxy statements of the firms in the sample here, many companies were simply unable to find an insurance company willing to underwrite a D&O liability policy for the firm.

[29]Delaware amended its corporate law with respect to limiting director liability in June, 1986. Many states have subsequently passed similar legislation. Indemnification agreements represent a contract between the firm and its officers specifying that the firm will cover the costs of potential litigation against management, regardless of the outcome.

to reincorporate solely to take advantage of director liability provisions in the destination state. As shown in Table 3, over 98% of all reincorporations for director liability reduction reasons were to Delaware.

There are several potential benefits of reducing director and officer liability. The following excerpt from the proxy statement of Drexler Technology Corporation (July 24, 1987, p.6) provides a fairly comprehensive discussion of these benefits:

> "The company seeks to attract and retain the most capable individuals available to serve as its officers and directors. Although the company has been able to obtain limited Director and Officer liability insurance, the Board of Directors believes that the terms and exclusions of such coverage are not satisfactory, and current conditions in the insurance industry have created significant uncertainties as to the continued availability of D&O insurance for the Company, especially with reasonable premiums and other satisfactory terms and conditions. The Board of Directors believes that the adoption of the reincorporation and the approval of the indemnification agreements could be a significant factor in (a) encouraging existing directors and officers to continue to serve in these capacities, (b) attracting capable and quality directors and officers in the future, and (c) encouraging Company directors and officers to make corporate decisions on their own merits rather than out of a desire to avoid personal liability, although the company has not to date experienced any difficulty in these regards."

While there are obvious advantages such as cost savings for firms that limit the liability of their agents (i.e., the costs of liability insurance are lowered), the overall impact of liability reduction measures and indemnification agreements on firm value is potentially ambiguous. For example, it is possible that management may be provided with liability protection to a degree that allows them to make self-serving business decisions.[30]

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[30]An example would be the case of a tender offer for the firm's securities. Liability protection may entice management to act in a manner consistent with job preservation rather than in the best interests of shareholders. Management could potentially oppose a

On the other hand, there are at least two additional potential positive effects of managerial liability reduction. One is the reduction of managerial exposure to nuisance suits filed by disgruntled shareholders.[31] A second, and the one most frequently cited by management, is that the firm may be able to attract and retain more qualified outside directors once it can provide those individuals with assurance that liability exposure will be minimal. Indeed, the evidence suggests that the crisis in the D&O insurance market had a significant impact on the ability of corporations to maintain the desired level of outside directorships. For example, according to a survey conducted by Heidrick and Struggles, an executive search firm, the percentage of outside directorships in the nation's 1000 largest industrial companies declined by nearly 6% (from 63.2% to 57.5%) from 1985 to 1986, the first year after the *Smith vs. Van Gorkom* decision. In the sample studied here, I was able to identify 7 firms from which outside directors resigned specifically citing the lack of sufficient liability protection.

Thus, there are at least three potential reasons to hypothesize an increase in shareholder wealth when a reincorporation is undertaken to establish director liability provisions, and one reason to expect a decrease. If a net positive market reaction is

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reasonable tender offer based on the business judgment rule with little or no liability ramification unless shareholders could prove that fiduciary duties were clearly violated. Cotter, Shivdasani, and Zenner (1995) provide evidence to support this conjecture. In their analysis examining the effect of board composition and incentives on tender offers, they find that managers are more likely to resist tender offers if they are protected by charter amendments limiting their legal liability.

[31]Jones (1993) reports that shareholders are responsible for approximately 52% of all reported director and officer liability claims in recent years. The out-of-pocket expenses (including indemnity and defense costs) average just under $5 million per case.

detected, further tests are needed to determine the source of the benefit. As part of this effort, an analysis of changes in board composition is conducted for the three year period including the year of the reincorporation and the following two years. A significant increase in outside representation over this period would suggest that much of the reaction (if positive) may be attributable to improved governance resulting from increased outside representation, while a finding of an insignificant difference in board representation would be interpreted as evidence to the contrary.

6.2.3 *Flexibility and/or predictability, tax/fee reduction, domicile reconciliation, and acquisition-related motives*

Reincorporations conducted for the purposes of (1) taking advantage of flexible and predictable corporate laws, (2) tax or fee reduction, (3) domicile reconciliation, and (4) facilitating acquisitions are broadly consistent with contractual efficiency theories. Unlike reincorporations conducted for antitakeover purposes and/or to reduce director liability, reincorporations conducted for these purposes do not involve managerial actions that may constrain the functioning of corporate governance mechanisms. Instead, the most plausible reason for these types of reincorporations is simply efficient contracting. In other words, managers apply the market value criterion and reincorporate the firm for these reasons when the benefits of doing so exceed the direct costs of the reincorporation process.[32] As a result, reincorporations conducted for these purposes should have a non-

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[32]Romano (1985) provides information concerning the costs of the reincorporation process. The results of her telephone inquiry revealed costs ranging from a few thousand

negative impact on shareholder wealth. The following paragraphs provide a brief discussion of these motives.

In the absence of the takeover activity and the D&O liability crisis of the 1980's, flexibility and/or predictability motives would likely have been the most frequently cited reasons for reincorporation. While there exists a wide range of firm-specific activities that prompt these reincorporations, the commonality among them is that managers believe they can be more efficiently conducted in corporate jurisdictions with supportive and predictable corporate laws. As was shown in Table 3, nearly 90% of the firms reincorporating for these reasons chose to relocate to Delaware.

The preeminence of Delaware in the market for corporate charters is attributable to at least three sources. First, Delaware has historically shown a propensity quickly to adapt its corporation laws to parallel significant developments in the corporate environment. This first-mover advantage has, over time, led many firms to reincorporate to Delaware (as evidenced by the windfall of reincorporations to Delaware for director liability reasons). Second, in relation to other jurisdictions, Delaware's corporate laws provide for a greater degree of flexibility in corporate financing and acquisition-related activities.[33] Finally, perhaps the most frequently cited explanation for Delaware's elite

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dollars, to three to four million dollars for large public companies. In a survey sent to the sample of firms studied here, the majority of the respondents suggested that the direct costs of reincorporation were negligible.

[33]For example, Delaware has taken a more permissive approach toward allowing non-traditional financial structures, such as multiple-class structures of common stock with unequal voting rights. In addition, other aspects of corporate law such as less stringent voting requirements for business combinations, increase the ease with which transactions can be carried out.

status among chartering jurisdictions is the predictability of its corporate laws. Due to its historical position as the most dominant state of incorporation, Delaware courts have passed down an unparalleled number of legal precedents that form a comprehensive body of case law. As a result of certainty and predictability provided by this body of law and the expert judicial system in Delaware, managers are better able to structure corporate transactions in manners that allow the corporation to avoid unnecessary litigation and legal fees.

Legal scholars view the comparatively large chartering fees of liberal states such as Delaware as a premium extracted in return for the use of an expert judicial system and access to a well-defined body of corporate case law. However, due to the fact that the fee structure is biased toward large corporations, for smaller firms these fees may seem excessive, particularly when the firm can be governed by substantially similar laws of other jurisdictions (such as the state in which the majority of operations are conducted), for a substantially lower cost. In addition to tax reduction reasons, there are further reasons that may lead managers to reincorporate in the state in which the majority of firm operations are conducted. As one example, when the majority of firm stakeholders are concentrated in a particular state, the firm may not only have more influence on legislators in that state, but may also be treated more favorably in court decisions if the proceedings are held in the state in which the firm's primary operations are conducted.

6.3 Chapter summary -- reincorporation motives

This chapter addressed the express and implied motives offered by managers for the decisions to reincorporate the firm. Section 6.1 provides the details on how these proposals were classified into similar types according to motives and provides an example for each. Section 6.2 examines these motives in detail, providing background information where appropriate. In this process, the general hypotheses presented in Chapter 4 are further developed.

CHAPTER 7

DEFENSIVE CONTRACTING AROUND THE REINCORPORATION

Proponents of the managerial entrenchment hypothesis suggest that managers will reincorporate into more liberal jurisdictions in order to adopt changes in the corporate governance structure and erect takeover barriers that entrench management. These antitakeover measures, or 'control provisions' may or may not be subject to shareholder approval. When these provisions come in the form of shark repellents (i.e., antitakeover charter amendments), shareholder approval is required. However managers can enact other restrictive measures such as poison pills, without prior shareholder approval.

The extant reincorporation research has not documented the frequency with which managers have used reincorporations to erect takeover barriers, even though Cary (1974) and numerous others suggest that they will do so. In order to shed some light on this issue, the proxy statements containing the reincorporation proposals and those for the next two years were examined to determine the frequency with which managers adopt specific antitakeover measures either coinciding with, or subsequent to, reincorporation. Since proxy statements contain only those measures that require shareholder approval, and thus, do not report when a firm establishes a poison pill defense, I used additional sources to identify firms that adopted poison pills within this time period.[34] The following two sections document the frequency with which control provisions are adopted along with the plan of reincorporation (section 7.1) and in the subsequent two years (section 7.2).

7.1 Control provisions coinciding with the reincorporation proposal

Consistent with the predictions of the managerial entrenchment hypothesis, the figures in Table 6 show that the majority of reincorporation proposals include contractual amendments that may entrench management. The two most common provisions include the elimination of cumulative voting rights (35%) and the establishment of a classified Board of Directors (22%). Both of these changes in the process of electing directors serve to entrench management by reducing the ability of non-management shareholder groups to gain representation on the board. The following section describes the significance of these changes in voting procedures.

7.1.1 *Board of director election procedures*

Under cumulative voting procedures, directors are voted upon jointly, with the candidates receiving the highest total vote count serving as directors for the next term. With this system in effect, minority shareholder groups are more likely to gain board representation since shareholders are able to pool all of their voting rights behind only the candidates they support, possibly even a single candidate.[35] With the elimination of

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[34]Those companies that adopted poison pill defenses were identified from the IRRC's *Corporate Takeover Defenses (1993)*, from the 1988-1995 editions of Clark Boardman's *Corporate Anti-takeover Defenses: The Poison Pill Device*, and from searches of the *Dow Jones News Retrieval Service*.

Table 6
Control provisions adopted as a part of the reincorporation plan

Table 6 presents the frequency of control provisions adopted as a part of the plan of reincorporation. Panel A contains the figures for the entire sample and for each classification of motives. Panel B provides the information for firms that offered a single motive for the decision. The information presented in the Table was taken from the proxy statements proposing the plan of reincorporation.

		Control-related provisions coinciding with the plan of reincorporation						
Panel A		eliminate cumulative voting	establish classified board	supermajority and/or fair price provisions	blank check preferred stock	dual-class capitalization	state takeover provisions	business combination or voting restrictions
entire sample	%	35.44%	22.25%	19.51%	14.01%%	2.20%	16.21%	7.14%
n=364	n	129	81	71	51	8	59	26
antitakeover motives	%	53.66%	39.02%	32.20%	20.00%	3.90%	22.44%	11.22%
n=205	n	110	80	66	41	8	46	23
liability reduction	%	38.73%	21.08%	16.18%	12.75%	0.98%	15.69%	7.84%
n=204	n	79	43	33	26	2	32	16
flex./predictability	%	21.74%	9.57%	13.04%	16.52%	3.48%	17.39%	7.83%
n=115	n	25	11	15	19	4	20	9
tax/fee reduction	%	10.00%	12.50%	15.00%	7.50%	0.00%	20.00%	7.50%
n=40	n	4	5	6	3	0	8	3
domicile reconciliation	%	21.05%	5.26%	10.53%	5.26%	0.00%	36.84%	10.53%
n=19	n	4	1	2	1	0	7	2
acquisition related	%	33.33%	0.00%	33.33%	33.33%	0.00%	0.00%	0.00%
n=6	n	2	0	2	2	0	0	0

		Control-related provisions coinciding with the plan of reincorporation						
Panel B		eliminate cumulative voting	establish classified board	supermajority and/or fair price provisions	blank check preferred stock	dual-class capitalization	state takeover provisions	business combination or voting restrictions
antitakeover only	%	59.18%	55.10%	51.02%	22.45%	4.08%	18.37%	6.12%
n=49	n	29	27	25	11	2	9	3
liability reduction only	%	17.64%	1.47%	0.00%	4.41%	0.00%	4.41%	1.47%
n=68	n	12	1	0	3	0	3	1
flex./pred. only	%	3.33%	0.00%	0.00%	10.00%	0.00%	6.67%	0.00%
n=30	n	1	0	0	3	0	2	0
tax/fee reduction only	%	0.00%	0.00%	0.00%	6.67%	0.00%	20.00%	6.67%
n=15	n	0	0	0	1	0	3	1

a. With the exception of the state takeover provisions category, the remaining control provisions are put to shareholder vote. However, consistent with the findings of Bhagat and Jefferis (1991), many of the provisions are "bundled" along with the plan to reincorporate and are therefore not voted upon on isolation. In addition, many of the provisions are not mentioned in the notice of the meeting, where agenda items are presented. Frequently, the only mention of these so-called "hidden" amendments is in the text of the proxy statement.

cumulative voting rights, shareholders lose the ability to pool their voting support, and as a result, the probability of a minority group gaining board representation is drastically reduced. Instead, each director is voted upon separately, with shareholders casting one vote per voting-share held. Under such a 'majority voting' system, it is possible for a shareholder group holding as much as 49% of the firm's voting stock to fail to gain board representation since 49% voting power does not constitute a majority.

Classified board provisions divide directors into designated classes (usually three) and provide that only one class is to be elected in any given year. Under this staggered system, board continuity is improved since directors are generally elected to three year terms, rather than the traditional one-year tenure. Such classification makes it difficult to alter the composition of the board in a timely fashion. This feature improves management's position in control attempts since it extends the time required to gain effective board control (i.e. majority representation) to include at least two annual meetings, even after voting control has been successfully wrested from the current management team. Most classified board proposals include a lock-in provision, which ensures the provision's effectiveness by requiring a supermajority vote to repeal or alter the board classification scheme.

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[35]For example, with cumulative voting and annual director elections, a stockholder or minority group holding 21% of the corporation's voting rights is assured representation on a board consisting of at least 5 members since a maximum of 20%, or 1/5 of the votes cast would be required to elect any single candidate.

7.1.2 *Additional antitakeover measures*

In addition to the changes in voting procedures, management frequently adopts additional measures to improve its bargaining power in the event of a takeover attempt. For example, one-fifth (20%), of the sampled firms adopted supermajority/fair price amendments along with the plan of reincorporation, while (14%) of the firms established blank check preferred stock. Furthermore, 7% adopted restrictions on blockholders' ability to vote their shares or enter into business combinations without prior management approval and 2% conducted a dual-class recapitalization. Finally, while not necessarily citing any specific actions, managers of 16% of the firms mention their intent to take advantage of (or alternatively, not opt out of) the antitakeover provisions in the new state of incorporation. Coinciding with the proposal to reincorporate, fully 225 (62%) of the sampled firms adopt at least one provision that either restricts shareholder voting rights or has other potential antitakeover implications.

Outside of the changes in board of director election procedures, the most common defensive charter amendment adopted (20%) is a supermajority amendment or a supermajority/fair price amendment, with the latter commonly referred to in the financial literature as simply a fair price amendment. A supermajority amendment stipulates that all control-related transactions must have the approval of a 'supermajority' (typically 2/3) of the voting shares before they can be carried out. The typical fair price amendment requires either supermajority voting approval for all offers that are not approved by the target company's board of directors, or that all shareholders receive a so-called 'fair price' for their shares. Although the definition of 'fair price' varies across firms, it is typically determined to be the highest price at which shares were tendered to the bidder during a specified time period. Several authors suggest that fair-price amendments can be beneficial since they allow target shareholders to hold out and bargain for the largest takeover premium without facing the possibility of getting caught at the tail end of a 'two-tiered' tender offer.[36] Jarrell and Poulsen (1987) suggest that fair-price amendments are one of the least restrictive defensive measures and provide evidence that they are not as harmful as other takeover defenses. Their study is reviewed in chapter 3.

Fourteen percent of the sampled firms authorize preferred stock as a part of the plan of reincorporation. Usually, management reserves the right to later establish the rights (voting, dividend, conversion, etc.) associated with the newly authorized stock. In these cases, management is said to possess a 'blank check' since they can tailor the issue's characteristics to better suit its intended use. One such use is to fend off hostile takeovers. Blank-check preferred stock provides management with a great deal of defensive flexibility in the presence of a hostile takeover attempt. Probably the most controversial, yet effective, defensive use of preferred stock is in the creation of a poison pill defense. Once blank check preferred stock has been authorized, management can, without further shareholder approval, use this security as the primary ingredient in a poison pill defense. To create a poison pill, managers grant existing shareholders the right to purchase shares of the authorized preference stock, with the rights contingent upon (1) whether or not an outside party surpasses a threshold level of holdings, or (2) whether or not the firm

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[36]For example, see DeAngelo and Rice (1983), Jarrell and Poulsen (1987), and Pound (1987).

receives a tender offer for its shares. In the absence of at least one of these triggering events, the rights have no material value. However, once the poison pill is triggered, the rights are activated, and can be used by their holders to convert shares of the preference stock into common shares at a substantial discount from market prices. As shareholders exercise their right to convert their preferred shares into common shares at extremely favorable prices, the relative voting power of the bidder is diluted, greatly increasing the resources needed to gain working control of the target company.

As an alternative to a poison pill defense, management can privately place preferred stock with special voting rights in the hands of friendly parties. A private placement of this nature not only allows the firm to raise additional capital, but also increases the proportion of votes aligned with management.

Seven percent of the sampled firms either added, or did not opt out of, provisions that restrict the ability of blockholders to engage in future business combinations with the firm or restrict the ability of blockholders to exercise fully the voting rights associated with their position. The typical business combination restriction prohibits a blockholder from entering into any business combination with the firm within a specified time period (usually 2 to 5 years), unless the blockholder receives board of director approval prior to surpassing a threshold level of shares (e.g., 10% to 20%). These restrictions, frequently referred to as freeze-out laws, force potential acquirers to negotiate with management prior to accumulating a large position in the company and force the postponement of any combination in which the potential acquirer failed to obtain management's prior consent.

In addition to the restrictions on business combinations, managers also take advantage of state corporation laws allowing the firm to place restrictions on the voting rights of large blockholders. These laws, termed control-share acquisition laws, require blockholders surpassing a threshold level (typically 20%) to gain the approval of the majority of all voting shares and the majority of disinterested shares before the blockholder can exercise voting rights beyond the threshold level. In the event the voting rights are not approved, the target firm often has the right to purchase the shares from the blockholder at market prices. Both of these restrictions on the rights of large blockholders or potential bidders are a result of second and third-generation state takeover laws enacted during the latter half of the 1980's. In many cases, management must 'opt out' of coverage by these laws, otherwise they become effective upon reincorporation. Karpoff and Malatesta (1989) provide an in-depth discussion of these restrictions in their analysis of second-generation state takeover laws.

Eight of the sampled firms (2.20%) conducted a dual-class recapitalization along with the plan of reincorporation. Such a recapitalization can insulate management from future takeover threats by placing a disproportionate amount of voting rights under managerial control.[37] While dual-class recapitalizations can have a significant effect on corporate control, there are many potential benefits that can arise out of a dual-class

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[37]For example, in the sample here, Richardson Electronics, LTD, reincorporated from Illinois to Delaware to effect a dual-class recapitalization. As a result of the recapitalization, (Chairman and CEO) Edward J. Richardson's voting power would increase from 58.2% to a maximum of 88.4% if all shareholders other than Mr. Richardson were to convert fully their non-transferable class B shares into common shares.

structure. For example, dual-class structures can provide a means for closely held firms to raise additional capital without losing their closely held status. Managers of firms proposing dual-class reorganizations frequently use this rationale for their proposals, suggesting that the new capital structure will allow the company to freely exploit future investment and acquisition opportunities without the possibility of losing control to outside parties.

7.1.3 *Bundled and hidden amendments*

Similar to the findings of Bhagat and Jefferis (1991) in their analysis of firms adopting antitakeover charter amendments, many of the managerial entrenchment provisions represented in Table 6 are "bundled" along with the plan to reincorporate. Of the 364 firms studied here, 162 (45%) bundle at least one provision with antitakeover implications as a part of the reincorporation proposal. As a result, such provisions are not put to a separate vote. Instead, shareholders are forced to vote either for, or against the entire proposal. This bundling of provisions increases the likelihood of ratification, even if a provision in isolation is harmful to shareholders. Bhagat and Jefferis suggest that management's decision to bundle antitakeover amendments is a function of the voting shares over which management exerts influence. When insiders control a large percentage of the firm's voting rights, there is little need to bundle harmful amendments. However, as the level of insider voting control decreases, managers are more likely to resort to bundling controversial items, such as antitakeover amendments along with other, less-controversial proposals to ensure passage.

In addition, many of the contractual changes with control implications come in the form of "hidden amendments." Since the typical reincorporation involves an exchange of the set of contracts governing the firm, it is easy for management covertly to incorporate material changes to the firm's governance mechanisms. 82 of the sampled firms (23%) implemented hidden amendments. As one example, shareholders frequently lose their right to cumulate their votes as a result of the reincorporation, even though the issue of cumulative voting rights is not mentioned as an agenda item on the proxy statement. Instead, in many cases the only mention of the change in voting procedures is buried deep within the text of the proxy statement, such as in the new corporate charter or the corporate bylaws in the destination state. Frequently, the only way to determine the true impact of the reincorporation on the firm's governance mechanisms is to read carefully the corporate charter and bylaws, and to rely on management to point out the material changes.

7.2 Control provisions adopted within 2 years of the reincorporation proposal

Table 7 reports the frequency of control-related provisions either proposed to shareholders for approval or otherwise enacted by corporate managers in the two year period subsequent to the reincorporation. With the exception of poison pill defenses, the remaining provisions are charter amendments that require shareholder approval. In order to establish a poison pill, however, managers need only an authorized financial security such as blank-check preferred stock to provide a mechanism for the defense. As shown in

Table 7
Control provisions adopted in the two years subsequent to reincorporation

Table 7 presents the frequency of control provisions adopted in the two proxy seasons subsequent to the reincorporation. Panel A contains the figures for the entire sample and for each classification of motives. Panel B provides the information for firms that offered a single motive for the decision. The information in the Table was taken directly from proxy statements.

Panel A		Control-related provisions adopted within 2 years of the reincorporation						
		eliminate cumulative voting	establish classified board	supermajority and/or fair price provisions	blank check preferred stock	dual-class capitalization	business combination or voting restrictions	established poison pill defense
entire sample	%	1.1%	3.57%	5.22%	1.37%	2.47%	2.20%	16.76%
n=364	n	4	13	19	5	9	8	61
antitakeover motives	%	0.49%	1.46%	4.88%	0.98%	2.43%	2.93%	18.53%
n=205	n	1	3	10	2	5	6	38
liability reduction	%	1.47%	2.45%	4.90%	0.98%	0.98%	1.96%	21.07%
n=204	n	3	5	10	2	2	4	43
flex./predictability	%	0.87%	6.96%	6.10%	0.87%	3.48%	0.87%	12.17%
n=115	n	1	8	7	1	4	1	14
tax/fee reduction	%	0.00%	5.00%	7.50%	2.50%	2.50%	2.50%	5.00%
n=40	n	0	2	3	1	1	1	2
domicile reconciliation	%	5.26%	5.26%	0.00%	0.00%	0.00%	0.00%	5.26%
n=19	n	1	1	0	0	0	0	1
acquisition related	%	0.00%	16.67%	0.00%	0.00%	0.00%	0.00%	33.33%
n=6	n	0	1	0	0	0	0	2

Panel B		Control-related provisions adopted within 2 years of the reincorporation						
		eliminate cumulative voting	establish classified board	supermajority and/or fair price provisions	blank check preferred stock	dual-class capitalization	business combination or voting restrictions	established poison pill defense
antitakeover only	%	0.00%	0.00%	4.08%	2.04%	4.08%	4.08%	20.41%
n=49	n	0	0	2	1	2	2	10
liability reduction only	%	2.94%	4.41%	5.88%	2.94%	0.00%	1.47%	20.59%
n=68	n	2	3	4	2	0	1	14
flex./pred. only	%	0.00%	10.00%	10.00%	3.33%	10.00%	0.00%	6.67%
n=30	n	0	3	3	1	3	0	2
tax/fee reduction only	%	0.00%	0.00%	0.00%	0.00%	6.67%	6.67%	6.67%
n=15	n	0	0	0	0	1	1	1

Table 6, managers frequently seek authorization for the preferred stock at the time of the reincorporation.

The figures in Table 7 suggest that managers typically do not follow up the reincorporation with a series of antitakeover charter amendments in the next two proxy seasons. Rather, the collective evidence presented in Tables 6 and 7 indicate that the majority of contractual changes with control implications (at least those that are subject to shareholder ratification) occur at the time of the reincorporation. However, nearly 17% of the sample established a poison pill defense with 2 years of the reincorporation. As noted earlier, these mechanisms do not require shareholder approval. Only 17 (5%) of the firms had a poison pill in place prior to the reincorporation.

7.3 Chapter summary

Viewed collectively, the evidence presented in this chapter shows that the majority of reincorporations contain charter amendments that may entrench management. Managers frequently bundle or hide these amendments in the reincorporation proposal to facilitate their passage. In the two years subsequent to reincorporation, managers continue to adopt antitakeover measures. Although the majority of defensive charter amendments coincide with the reincorporation, nearly 17% of the sampled firms erected poison pill defenses within two years after the reincorporation. In numerical terms, the proportion of firms that implemented at least one of the control provisions depicted in Tables 6 and 7 increased by 9 percentage points over the two year follow-up period, from

62% at the time of the reincorporation, to 71% by the two year anniversary of the change in legal domicile.

The figures presented in Tables 6 and 7 also highlight the potential difficulties in characterizing individual reincorporation proposals as being conducted for antitakeover purposes. Frequently, managers placed emphasis on other reasons for reincorporation such as director liability reduction while at the same time the new corporate charter in the destination state contained additional provisions (as shown in Table 6) that may have an antitakeover effect. In those cases, even though managers did not explicitly mention antitakeover reasons, I followed the general rule of classifying a reincorporation as having implied antitakeover motives if the reincorporation proposal contained at least <u>two</u> charter amendments having potential antitakeover implications. Thus, although there is not necessarily a one-to-one mapping between those firms classified as having antitakeover motives and those firms adopting charter amendments that may have an antitakeover effect, the correlation is nonetheless extremely high.

CHAPTER 8

RESEARCH METHODOLOGY

Thus far, this study has raised questions regarding why firms reincorporate and how the recontracting that occurs in reincorporations should effect security prices. The sample constructed for the analysis here suggests that the motives for reincorporation have changed substantially over time, with the dominant motives for recent reincorporations being antitakeover motives and director liability reduction reasons. Furthermore, as was shown in chapter 7, recent reincorporations have involved a substantial amount of defensive recontracting. In light of these facts, the hypotheses developed in chapter 4 and further refined in chapter 6 imply the existence of relationships between reincorporation motives, firm attributes, and shareholder wealth. In order to test these propositions, a variety of empirical research methodologies are employed. The goals of these empirical tests are (i) to determine the economic significance of the reincorporation decision, (ii) to identify those firm attributes that may precipitate a change in corporate jurisdictions, and (iii) to identify those reincorporation motives and firm characteristics that play an influential role in how these decisions are perceived by investors. The specific methodologies that are used to test these relationships include: event study methodology, tests of capital market and operating performance, logistic regressions, cross-sectional regressions of abnormal returns, and various univariate statistical tests. This chapter provides the background for these methodologies, while chapter 9 presents the results of the empirical tests based on these techniques.

8.1 Event study analysis

Event study methodology is employed in order to document investor reaction to both the announcement and the approval of reincorporation proposals, and to obtain the residuals to be used in cross-sectional tests. The market model methodology used in this analysis involves a two step procedure in order to ascertain whether a significant security price reaction is present. This methodology was introduced by Fama, Fisher, Jensen, and Roll (1969) and has since been utilized by numerous researchers in order to determine security price reactions to a wide range of corporate events. A detailed discussion of market model methodology can be found in Brown and Warner (1980, 1985).

In the first step of the analysis, a simple linear regression is estimated, from which, market model parameters are obtained for each security in the sample. In the second step, abnormal returns are computed for each firm by subtracting the returns as predicted by the estimated market model parameters from the actual returns observed during the analysis period. Statistical tests are then conducted to determine whether or not the average cross-sectional abnormal returns attributable to the event analyzed are significantly different from zero. These abnormal returns may then be utilized in further cross-sectional analyses.

In specific, the market model utilized in this analysis is based on the assumption that the return generating process is represented by a stationary market model:

$$\tilde{R}_{it} = \alpha_i + \beta_i \tilde{R}_{mt} + \varepsilon_{it},$$

where $\tilde{R}_{it}$ is the observed rate of return for security i on day t, $\tilde{R}_{mt}$ is the rate of return on the market portfolio of common stocks on day t, and ε_{it} is a random disturbance term which is assumed to be; normally distributed with mean zero, serially uncorrelated, and to have constant variance over time. The parameter α_i represents the portion of the average return on security i that is not attributable to market movements, β_i is a measure of the sensitivity of the return on security i to the market return, and $\beta_i R_{mt}$ represents the portion of security i's return on day t that is due to market-wide factors.

The parameters $\hat{\alpha}_i$ and β_i are the ordinary least square regression (OLS) estimates over a period of 200 trading days (-250 to -51) preceding the event day. The market portfolio used in the estimation was the *CRSP* equally-weighted index, comprised of all NYSE, AMEX, and OTC firms listed on the tapes.[38] Using the parameters obtained during the estimation period, abnormal returns during the announcement period are computed as:

$$AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{mt}),$$

where AR_{it} is the estimated portion of security i's return that is due to the event under consideration.

Daily abnormal returns are computed as an equally weighted average of the individual security abnormal returns for each event day relative to the announcement:

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[38]Past researchers have shown that the choice of market portfolio is of little significance in relatively short event windows. The equal-weighted index is used as the proxy for the market portfolio in this analysis since the majority of the firms in the analysis are smaller firms. Tests using the value-weighted index provide similar results.

$$\overline{AR}_t = \sum_{i=1}^{N}(AR_{it} / N),$$

where N represents the number of securities in the portfolio at time t.

Tests of statistical significance for daily abnormal returns are conducted using the following test statistic:

$$t = \overline{\overline{AR}}_t / S(\overline{\overline{AR}}),$$

where $\overline{\overline{AR}}_t = (\sum_{i=1}^{N} A\hat{R}_{it}) / N$, $S(\overline{\overline{AR}}) = \sqrt{(1/N)}$.

and $A\hat{R}_{it} = AR_{it} / S_t(AR_i)$,

where

$$S_t(AR_i) = (S_i^2(1 + 1/T + (R_{mt} - \overline{R}_m)^2 / \sum_{t=1}^{T}(R_{mt} - \overline{R}_m)^2)^{1/2},$$

where

S_i^2 = the residual variance for security i from the OLS regression,

T = the number of days used in the OLS estimation of the market model parameters,

N = the number of firms in the portfolio analyzed,

$\overline{R}_m$ = the average market portfolio return over the estimation period.

Based on the standard market model assumption that returns are normally distributed, each standardized abnormal return ($A\hat{R}_{it}$) is distributed as Student-t with a variance of T/(T-2). If the abnormal returns are cross-sectionally independent, under the Central Limit Theorem, the average standardized abnormal return $\overline{\overline{AR}}_t$ is distributed asymptotically normal with variance of T/((T-2)N). Since T is large, the variance of $\overline{\overline{AR}}_t$ is converges toward 1/N.

Tests of statistical significance for cumulative abnormal returns (CAR) are conducted using the following test statistic:

$$T_c = \overline{CAR}_J \,/\, S(\overline{\overline{AR}}),$$

where

$$\overline{CAR}_J = (1/N \sum_{i=1}^{N}((\sum_{j=1}^{J} A\hat{R}_{it})/\sqrt{J})),$$

with J representing the number of days in the interval over which returns are cumulated.

8.2 Measuring firm performance

Financial researchers have employed a host of different techniques in order to draw conclusions about the relative levels of capital market and operating performance for their samples of firms. While these techniques vary greatly in terms of complexity, their common goal is to accurately determine the extent to which the measured levels of performance for the sample firms deviate from expectations. Thus, a valid empirical test must not only measure absolute levels of firm performance, but also minimize the potential for bias that may occur in determining the 'benchmark', or expected level of performance. The performance tests conducted in the analysis here place particular emphasis on developing an accurate benchmark for comparison, which includes controlling for potential size-induced bias in the tests of capital market performance, and industry effects in the case of operating performance. These methodologies are discussed further in the following two sections.

8.2.1 *Capital market performance*

Traditionally, financial researchers have relied upon market-model methodologies to measure capital market performance over both short and long measurement intervals. While market-model methodologies are well specified for shorter event windows (see Brown and Warner (1980, 1985)), several recent studies emphasize the importance of other factors in the longer-term return generating process. The most persistent of these other factors over time has been the size effect, as documented by numerous scholars including Banz (1981), Reinganum (1981), and Dimson and Marsh (1986).

Dimson and Marsh (D&M) demonstrate how market methodologies can result in biased estimates of long-term capital market performance due to size effects. This is particularly the case when either (i) measurement intervals are long, or (ii) the firms in the analysis differ systematically in size or weighting from market indices traditionally used in market-model methodologies. D&M suggest that these sources of bias can be avoided by controlling for firm size and incorporating a longer-term buy-and-hold approach as opposed to the continual reweighting inherent in the traditional abnormal return methodologies.

For these reasons, the tests of long-run capital market performance conducted in this study and presented in the following chapter (Table 9) are based on a yearly buy-and-hold approach as proposed by Dimson and Marsh (1986) which explicitly controls for size effects.[39] This is especially important in this analysis because as shown in Table 5, reincorporating firms are generally smaller in capitalization than the typical public corporation. I use a size-decile adjusted portfolio benchmark instead of using a matched firm procedure because of the difficulty in finding a suitable match for many of the sampled firms given the relatively short time periods over which many of the firms were publicly traded.

Size decile adjusted yearly holding period returns are measured as

$$\varepsilon_{it} = r_{it} - r_{st} ,$$

where r_{it} = the holding period return of firm i in the year t (relative to the reincorporation).

r_{st} = the holding period return of an equally weighted portfolio of all firms listed on the same exchange and having the same size decile classification as firm i.

Annual size-decile classifications are based on both the exchange upon which firm' securities are traded and the market value of firm' equity. These classifications were taken directly from the *CRSP NYSE/AMEX* file and the *CRSP NASDAQ* file and were updated annually to control for possible changes in firm size.

Tests of statistical significance for mean size-decile adjusted holding period returns are based on standard t-tests which are calculated based on the cross-sectional variance of

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[39]Dimson and Marsh also provide a similar technique that also accounts for differences in firm' betas. Their results indicate that both size-adjusted and size and beta-adjusted returns are substantially similar, indicating that the majority of the potential bias lies with the size-effect. For this reason, and the relatively short trading periods for many of the sampled firms, I follow their size-adjusted approach to determine benchmark performance levels.

the excess returns in the relevant period. However, since mean excess returns may be influenced by a few firms that perform either exceptionally well, or exceptionally poorly, median figures are also emphasized. The Wilcoxon signed-ranks test is used to draw inferences about median levels of size-decile adjusted capital market performance.

8.2.2 *Operating performance*

The analysis of firm operating performance focuses on comparing the operating performance for the sample of reincorporating firms with the expected levels of operating performance for firms conducting operations in the same industries. I examine firm operating performance by measuring the levels of operating income before depreciation (OIBD) in the years surrounding the sample reincorporations.[40] In order to control for differences in firm size and to facilitate valid comparisons, OIBD (*Compustat* data item 13) is scaled for each firm by the book value of total assets (*Compustat* data item 6) for each corresponding year. This scaled variable provides a measure of the efficiency of asset utilization. As a benchmark operating performance measure, I use the median ratio of OIBD/TA for all firms in the same industry (4-digit SIC code) as each sample firm.

Because operating performance measures are often highly skewed, the mean of the firm level OIBD/TA ratios may be particularly sensitive to extreme values. In order to control for this possibility and minimize the influence of outliers, firm-level OIBD/TA

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[40]Several recent studies have also used scaled OIBD as a measure of overall operating profitability. These studies include Healy, Palepu, and Ruback (1992), Denis and Denis (1993), and Jain and Kini (1994).

ratios falling beyond the 1% and 99% levels are set to the 1% and 99% levels respectively. Further, emphasis is also placed on median values, which are not as sensitive to departures from normality. Paired comparison t-tests and Wilcoxon signed-ranks tests are used to test for significant differences between actual and expected levels of firm operating performance.

8.3 Logistic regressions

Binary logistic regressions are used in this study in those instances where the dependent variables represent qualitative, or binary outcomes. An example of a binary dependent variable in this setting is a dummy variable set to one if a publicly-held firm chose to reincorporate during the sampled period, and zero otherwise. In this case, a logistic regression is more appropriate than the traditional linear regression since the dependent variable represents a discrete rather than continuous outcome, that has a lower bound of 0 and an upper bound of 1. The primary benefit of a logistic regression in this case is that unlike an ordinary linear least squares regression, the logistic regression is based on the logistic distribution, which is represented by an S-shaped curve bound in the interval (0,1), which matches the specification of the discrete dependent variable. Thus, in a logistic regression, the probability of an observed response such as a reincorporation (Y=1) or not (Y=0) can be modeled as a function of a vector (x) of explanatory variables representing firm characteristics such as firm size, ownership concentration, sales growth, etc., such that,

$$\text{Prob}[Y=1] = F(x,\beta), \text{ and}$$

$$\text{Prob}[Y=0] = 1 - F(x,\beta)$$

In this setting, the set of parameters, β, reflects the impact of changes in x on the probability that a publicly held firm chooses to reincorporate. Thus, the logit model is specified as,

$$\text{Prob}[Y=1] = \frac{\exp(\beta'x)}{1+\exp(\beta'x)} \quad ,$$

and, $\log[P/(1\text{-}P)] = \beta'x$,

where P = Prob[Y=1] and log[P/(1-P)] is the log of the odds ratio.

There are several uses of logistic regressions in the financial literature in cases where dependent variables are of a qualitative nature, such as in this case, whether or not a firm chooses to reincorporate. For example, Palepu (1986) utilizes a logistic regression to model the likelihood of firm acquisition as a function of firm attributes. In the following chapter, I present the results of a binomial logit analysis similar to that used by Palepu to test the hypotheses presented in chapter 4 that imply that both the probability that a firm will reincorporate and that the motives offered for reincorporations are a function of firm attributes.

8.4 Cross-sectional analysis

The hypotheses presented in chapter 4 and further refined in the chapter 6 discussion of reincorporation motives suggest that security price reactions to reincorporations will vary in the cross-section. Although a great deal of this variation is likely to by captured by the express and implied reincorporation motives of corporate managers, there are also several firm-specific characteristics that may play a significant role in how these decisions are perceived in the capital markets. This is especially the case when antitakeover motives and/or director and officer liability reduction motives are cited. In both of these cases, compelling arguments can be made that imply that the shareholders of firms exhibiting certain characteristics will benefit to a greater extent, or suffer to a greater degree when these reincorporations take place.

Cross-sectional regressions of abnormal returns are used to test these relationships. In these regressions, the dependent variables are the abnormal returns (AR) and cumulative abnormal returns (CARs) from the event-day analysis. Those firm-level factors that may impact security price reactions are used as the regressors. Cross-sectional analyses are conducted for those firms citing antitakeover motives and director liability reduction motives. These tests are not conducted for firms reincorporating for other reasons since there exists few hypotheses that imply that their abnormal returns will either significantly differ from zero, or vary significantly across firms.

8.5 Univariate tests

In addition to the previously discussed empirical methodologies, univariate tests are used to test for changes in certain firm characteristics in the periods subsequent to the reincorporations. Specifically, I use paired comparison t-tests to test the hypothesis that ownership concentration will decline subsequent to reincorporations and also to test whether or not firms citing director liability reduction motives increase outside board representation in the years following their reincorporations.

8.6 Chapter summary

This chapter provided the mechanics of the empirical research methodologies used to test the hypotheses generated in this study. The results of the empirical tests based on these methodologies are presented in chapter 9.

CHAPTER 9

EMPIRICAL RESULTS

9.1 The effect of the reincorporation decision on security prices

To determine shareholder reaction to management's decision to reincorporate, the standard event study analysis using market model estimates as discussed in chapter 8 is employed. Market model parameters are estimated over the 200 day period, -250 to -51 relative to the event date analyzed. The CRSP equal-weighted index is used to proxy market returns. To mitigate the effects of non-synchronous trading and the influence of low-priced securities, firms with trading volume during less than 70% of the market model estimation period and/or with stock prices less than $3 are not included in the security price analysis. Firms with coinciding events or material other announcements are also excluded.

The event-day analysis is conducted around two dates, both of which reveal information regarding the change of legal jurisdictions. These two dates include (i) the earliest announcement of management's intent to reincorporate, and (ii) the date on which the proposal was approved by the firm's securityholders. The *Wall Street Journal Index* and the *Dow Jones News Retrieval Service* were searched to identify the earliest announcement of management's decision to change the corporate domicile. The search of these sources revealed that it is rare for the first public release of management's intention to reincorporate to occur in the financial press. Instead, proposals to change corporate jurisdictions are usually first presented to shareholders in proxy statements. Out of the 364 firms in the analysis, there were only 23 cases (6.3%) where the business press announced the proposal in advance of when the proxy statements containing the proposal were mailed to shareholders. In contrast, the majority of the press announcements report that the firm's shareholders have approved the reincorporation proposal, and thus, coincide with, or immediately follow, the date of the shareholder meeting.

In the absence of an earlier press announcement providing the details of the reincorporation, the proxy mailing date is used as the initial announcement date.[41] Although all of the proposals in this analysis eventually passed, there were 8 cases (2.2%) where management had not received the required level of voting support by the time of the originally scheduled shareholder meeting. In these cases, the meetings were adjourned to a later date to provide shareholders with additional time to return their proxies. For these firms, the earlier of the date of the adjourned meeting or the press announcement revealing that the proposal had passed is used as the date of shareholder approval.

The alternative hypotheses derived from the literature and presented in chapter 4 (i.e., contractual efficiency vs. managerial entrenchment) indicate that the market's reaction to a reincorporation is likely to be a function of management's underlying motive

[41]Several studies have used either proxy mailing dates or proxy signing dates as the announcement date for corporate control related proposals when earlier announcements occur infrequently in the business press. These studies include DeAngelo and Rice (1983), Linn and McConnell (1983), and Jarrell and Poulsen (1987). The proxy signing date and the proxy mailing date are usually the same, however the proxy signing date may precede the mailing date by a few days.

for the move. While these hypotheses are necessarily competitive, it is important for the researcher to avoid playing them off directly against each other and stopping at an overly general conclusion such as: "Overall, the evidence does not support hypothesis A." This is especially important for an event of this nature, where there exists a wide variety of different motives, some of which fall clearly under only one of the existing hypotheses. Instead, since it is likely that both of the hypotheses in the literature are situationally correct, a great deal of insight can be gained by correctly identifying those situations that are consistent with one or the other of the alternative hypotheses. With this in mind, the information in Table 8 is partitioned into four panels. Panel A presents the aggregate results, and thus, does not distinguish between the firms in the sample based on stated motives. Panel's B and C however, disaggregate the sample into those firms with motives that are broadly consistent with the alternative hypotheses in the literature. Panel B presents the results for those firms with motives that are on the surface, consistent with the efficient contracting hypothesis and Panel C presents the results for those firms with motives that are consistent with managerial entrenchment arguments. Panel D then provides the aggregate figures for each categorization of motives.

This disaggregation serves two general purposes. First, it clearly illustrates how the wealth effects of reincorporations conducted for different purposes can offset one another, and lead researchers who fail to adequately consider managerial motives to conclude that the decision to reincorporate does not materially alter shareholder wealth. Second, the approach provides for clearer tests of the alternative hypotheses.

As noted earlier, the security price analysis is conducted surrounding two relevant dates; the date of the proposal announcement and the date on which shareholders approved the proposal. The figures surrounding the proposal announcement are presented in the left half of Table 8, while the corresponding figures surrounding the date of shareholder approval are presented in the right half of the Table.

As evident in Panel A, the abnormal security price reactions for the entire sample, although negative, give only a slight indication that reincorporations may be harmful to shareholders. Only the negative cumulative abnormal returns (CARs) averaging -0.69% (t = -1.84) over the 4 day interval (0,3) surrounding the date of shareholder approval show up as statistically significant, and then only at the 10% level. As is shown throughout the remainder of the Table, these aggregate results must be interpreted with caution, since they are the product of offsetting reactions to reincorporations conducted for alternative motives, some of which are consistent with contractual efficiency arguments (presented in Panel B) and others consistent with managerial entrenchment arguments (as presented in Panel C).

Panel B presents the results of the security price analysis for those firms that cited reincorporation motives that are in general, consistent with the contractual efficiency hypothesis. The first 3 categories in the Panel present the results for those cases where single motives were cited. These motives include: director liability reduction, flexibility or predictability of corporate laws, and tax or fee reduction. Firms that mentioned only domicile reconciliation motives or acquisition-related motives are not represented separately since only 2 firms offered domicile reconciliation motives exclusively and none

Table 8
Event day analysis

Table 8 presents the abnormal returns (AR) and cumulative abnormal returns (CARs) around the earlier of the first press announcement and the proxy mailing date, and also for the date of shareholder approval. Panel A presents the results for the entire sample, while Panel B provides the figures for those firms offering single motives that are consistent with contractual efficiency theories. Panel C presents the results for those firms which cited solely antitakeover motives, or with existing capital market pressures. Panel D presents the corresponding aggregate figures for each categorization of reincorporation motives. Market model parameters are estimated over the period -250 to -51 prior to the event day. To reduce the effects of nonsynchronous trading and the influence of low-priced stocks, firms with trading volume over less than 70% of the estimation period and/or stock prices less than $3 are excluded from the event day analysis. (test statistics in parentheses) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

		Proposal Announcement			Date of shareholder approval			
		t=0	CAR (0,3)		t=0		CAR (0,3)	
Panel A								
Entire Sample	AR	-0.15%	-0.24%	AR	-0.01%		-0.69%	
		(-0.41)	(-0.62)		(-0.06)		(-1.84)	*
	N	292	292	N	292		292	
Panel B	*Motives consistent with contractual efficiency theories*							
Liability reduction motives only	AR	-0.16%	1.19%	AR	0.80%	***	0.41%	
		(-0.17)	(1.61)		(2.65)		(1.47)	
	N	59	59	N	59		59	
Flexibility/predictability motives only	AR	0.04%	0.05%	AR	-0.06%		-0.25%	
		(0.80)	(0.69)		(-0.15)		(-0.36)	
	N	20	20	N	20		20	
Tax or fee reduction motives only	AR	0.11%	-1.14%	AR	-0.81%		-0.08%	
		(-0.07)	(-0.59)		(-0.77)		(-0.02)	
	N	13	13	N	13		13	
All firms mentioning only contractual efficiency motives	AR	0.01%	0.38%	AR	0.25%		-0.37%	
		(0.56)	(1.28)		(1.47)		(0.16)	
	N	115	115	N	115		115	
Panel C	*Motives consistent with managerial entrenchment theories*							
Antitakeover motives only	AR	-0.22%	-0.52%	AR	-1.18%	***	-1.67%	***
		(-0.40)	(-1.09)		(-3.25)		(-2.72)	
	N	45	45	N	45		45	
Firms facing capital market pressures	AR	1.01%	0.75%	AR	-1.59%	***	-2.89%	**
		(1.32)	(0.34)		(-3.29)		(-2.41)	
	N	22	22	N	22		22	
Pressured firms with antitakeover motives	AR	1.31%	1.29%	AR	-2.87%	***	-2.83%	**
		(1.55)	(0.74)		(-4.22)		(-1.99)	
	N	12	12	N	12		12	
All firms with entrenchment motives[a]	AR	0.06%	-0.33%	AR	-1.27%	***	-2.10%	***
		(0.01)	(-1.03)		(-4.10)		(-3.47)	
	N	63	63	N	63		63	

a. Represents all firms that cited solely antitakeover motives or faced capital market pressures in the year prior to reincorporation.

Table 8
Event day analysis
(continued)

Panel D presents the aggregate results of the event day analysis for each categorization of reincorporation motives (not mutually exclusive). Market model parameters are estimated over the period -250 to -51 prior to the event day (test statistics in parentheses). *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

		Proposal Announcement				Date of shareholder approval			
		t=0	CAR (0,3)			t=0		CAR (0,3)	
Panel D	*Aggregate results according to motives*								
All firms mentioning antitakeover motives	AR	-0.31%	-0.65%	*	AR	-0.17%		-0.78%	**
		(-1.07)	(-1.74)			(-1.24)		(-2.22)	
	N	167	167		N	167		167	
All firms mentioning liability reduction motives	AR	-0.08%	0.14%		AR	0.59%	***	0.12%	
		(0.04)	(0.33)			(2.77)		(0.49)	
	N	164	164		N	164		164	
All firms mentioning flexibility/predictability motives	AR	0.10%	-0.25%		AR	-0.25%		-1.49%	**
		(0.33)	(-0.40)			(-0.55)		(-2.25)	
	N	86	86		N	86		86	
All firms mentioning tax or fee reduction motives	AR	-0.44%	-1.75%		AR	-0.91%		-0.92%	
		(-1.02)	(-1.46)			(-1.56)		(-0.65)	
	N	32	32		N	32		32	
All firms mentioning domicile reconciliation motives	AR	-0.97%	-2.18%		AR	-0.89%		-1.12%	
		(-0.69)	(-0.60)			(-0.92)		(-0.56)	
	N	13	13		N	13		13	

Since only 6 firms cited acquisition-related motives and only 4 met the requirements for inclusion in the event day analysis, the results for this set of firms are not presented.

of the sample cited solely acquisition-related motives. Finally, the last category in Panel B presents the aggregate security price reactions for those firms that cited motives (in some cases, multiple motives) that are all consistent with contractual efficiency arguments.

The evidence presented for those firms mentioning only director liability reduction motives suggests that reincorporations for these reasons increase shareholder wealth. Over the 4 day window (0,3) surrounding the proposal announcement, abnormal returns cumulate to 1.19%, although these CARs are not quite significant at conventional levels (t = 1.61). However, in addition to the 1.19% CARs at the proposal announcement, the shareholders of these firms experienced a statistically significant increase in the value of their shareholdings averaging 0.80% upon the passage of the reincorporation proposal. The magnitude of this abnormal return is significant at the 1% level (t = 2.65). CARs (0,3) surrounding the date of shareholder approval total 0.41% (t = 1.47).

The security price reactions for both the set of firms citing solely flexibility/predictability motives and those citing only tax or fee reduction reasons do not statistically differ from zero over any of the windows considered. This insignificant reaction is nonetheless consistent with the contractual efficiency hypothesis in that reincorporations conducted for these purposes do not appear to harm shareholders. Further, the reactions for the collection of firms that mentioned reincorporation motives that are consistent with contractual efficiency theories also do not significantly differ from zero over any of the event windows. Viewed collectively, the results shown in Panel B illustrate that while reincorporations conducted for contractual efficiency purposes do not appear to harm shareholder wealth, only those reincorporations conducted for director liability reduction reasons elicit a significantly positive average capital market response.

Panel C presents the results of the analysis for those firms with express or implied motives that appear to be more consistent with managerial entrenchment theories. The four categories in Panel C include: those firms that cited solely antitakeover motives, firms that reincorporated in the midst of capital market pressures, firms that faced capital market pressures and specifically cited antitakeover motives and/or adopted takeover defenses in their plan of reincorporation, and finally, the collection of all firms with apparent entrenchment motives. Firms facing capital market pressures were identified from searches of the *Wall Street Journal Index*, and from additional news sources. Companies were classified as pressured if: (i) the firm was the subject of takeover rumors in the year prior to the reincorporation, (ii) the firm had recently received a tender offer, or (iii) if the firm had a large blockholder with expressed intentions to influence management.

As is shown at the top of the Panel, the shareholders of those firms mentioning only antitakeover motives experienced negative security price reactions over all event windows. Although the abnormal returns cumulate to -0.52% (t = -1.09) over the 4 day window surrounding the proposal announcement, only the abnormal returns associated with the approval of these defensive reincorporation plans are statistically significant. On the day of shareholder approval, security prices for this set of firms declined by an average of -1.18% (t = -3.25) and further declined over the 4 day window by an average of -1.67% (t = -2.72). Both are significant at the 1% level.

Interestingly, for both sets of firms facing capital market pressures, abnormal returns are positive (although not significant) surrounding the announcement of the reincorporation proposal, and significantly negative at the time when the proposal receives shareholder approval. For the entire set of firms facing capital market pressures, abnormal returns averaged -1.59% (1% sig. level) upon shareholder approval and declined even further to -2.89% (t = -2.41) over the 4 day window following the approval date. For the subset of these firms that also chose to adopt antitakeover measures, abnormal returns averaged -2.87% (t = -4.22) at the passage of the reincorporation plan and remain fairly constant at this level over the entire event window.

The collective results for all firms with entrenchment motives further illustrate how reincorporations for these purposes result in lower values of financial claims. Although the negative average security price reaction of -0.33% in the 4 days surrounding the proxy mailing date does not differ from zero at conventional levels, the declines in security values averaging -1.27% (t = - 4.10) upon the approval of the plan of reincorporation and cumulating to -2.10% (t = - 3.47) in the following 3 days are statistically significant at the 1% level.

Panel D presents the aggregate figures for each categorization of motives. Since the majority of managers (55%) offered multiple reasons for their decision, the results in Panel D must be interpreted with caution. Aside from the potential confounding effects arising out of multiple motives offered, the results shown in Panel D are in general, consistent with those in Panels B and C. Specifically, when antitakeover motives are cited, shareholder wealth declines over all event windows. 4-day CARs following both the announcement and approval of these reincorporations are significantly negative, averaging -0.65% (t = -1.74) and -0.78% (t = -2.22) respectively.

The overall subset of firms mentioning director liability reduction motives experienced a significantly positive revaluation in their security prices averaging 0.59% (t = 2.77) upon shareholder approval of these plans, despite the fact that over half of these proposals also included antitakeover measures. Finally, the security price reactions for the remaining classifications (flexibility and/or predictability, tax or fee reduction, and domicile reconciliation) are primarily negative. Only the 4-day CARs of -1.49% for the subset of firms citing flexibility and/or predictability motives are statistically significant (5% level). However, 74% of those firms citing flexibility or predictability motives also cited additional motives, frequently antitakeover motives. Therefore, with the positive reactions to those firms citing director liability reduction motives being the exception, the overall negative reactions detected and shown in Panel D are likely attributable to the confounding negative effects of the antitakeover measures also enacted.

Collectively, the results of the security price analysis presented in Table 8 imply that the shareholder wealth effects of reincorporation are dependent upon the motives cited, and actions ultimately taken by management. Consistent with the contractual efficiency hypothesis, those reincorporation proposals that do not include defensive maneuvering have at worst, non-negative implications for shareholder wealth. When reincorporations are conducted to reduce director liability exposure, shareholder wealth increases by statistically significant amounts. As noted earlier, there are at least three potential sources for this gain. Further tests presented later in this chapter are designed to identify the actual source of benefit. Consistent with the managerial entrenchment hypothesis, the majority of reincorporations include defensive maneuvering (as shown in chapter 7) and the shareholders of these firms experience a statistically significant decline in the value of their securities when these proposals are passed. Of those firms that used a reincorporation to establish takeover barriers, the magnitude of the negative reaction when these plans were approved was greater for firms facing immediate capital market pressures.

Interestingly, the results presented in Table 8 show that the most significant security price reactions occur when reincorporation proposals receive shareholder approval, as opposed to when the proposals are first presented to shareholders. While this is somewhat puzzling, it nonetheless explainable for at least two reasons. First, as discussed earlier, these proposals are rarely announced in the business press in advance of when the proxy materials are mailed to shareholders. Therefore, by default, the proxy mailing date represents the best surrogate for the initial announcement date. However, it is nonetheless unlikely that all shareholders will receive the information on the day of, or even the day immediately following the proxy mailing.[42] Second, given the complexity of many of the reincorporation proposals, it is also unlikely that shareholders will immediately form an opinion as to the proposal's effect on the value of their security holdings. Finally, based on searches of various news sources and on the responses to a

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[42]In addition, many proxy statements suggest that all of the proxy materials may not be mailed simultaneously. For example, it is not uncommon for a proxy statement to include a line such as "proxy materials are being sent to shareholders of record commencing on or about (day, month, year)."

questionnaire sent to the sampled firms, it is most common for the first press announcement of the decision to coincide with shareholder passage of the proposal.

9.2 Measures of firm performance

This section examines both the capital market performance and the operating performance of the sampled firms over time. Past researchers have arrived at differing conclusions with regard to the capital market performance of reincorporating firms. For example, Dodd and Leftwich (1980) (D&L) found that the firms in their 1927-1977 sample experienced significant cumulative abnormal returns averaging 30.25% in the 25 months preceding and including the month of the reincorporation. In contrast, Netter and Poulsen (1989) (N&P) found that in their later sample, shareholders experienced negative (although insignificant) cumulative abnormal returns averaging -17.7% over the same interval. Neither of these studies address the issue of operating performance, even though both D&L and later Romano (1985) suggest that reincorporations are most frequently conducted at the time of, or in anticipation of significant changes in financing and/or operating activities.

In the following two sections, I address these issues by analyzing both pre- and post-reincorporation capital market and operating performance. In addition to presenting aggregate figures as is done in past research, the corresponding figures are also presented according to managerial motives.

9.2.1 *Capital market performance of reincorporating firms*

Both D&L and N&P used market model methodologies to compute long run performance measures for their samples of reincorporating firms. However, in order to minimize the potential bias that may result from size effects and portfolio reweighting, I use the longer-term size-adjusted approach proposed by Dimson and Marsh (1986) and discussed in chapter 8. The results of these capital market performance tests are presented in Table 9. The figures in the Table represent the mean and medians of yearly holding period returns (HPRs) for the sampled firms net of the return on an equally-weighted portfolio of the securities of firms listed on the same stock exchange and having a similar equity capitalization as each of the sampled firms.

Table 9 provides the results of the capital market performance tests for the entire sample (Panel A), for those firms whose managers cited reincorporation motives consistent with contractual efficiency theories (Panel B), and for those firms with express or implied motives that are consistent with managerial entrenchment theories (Panel C). Tests of statistical significance are based on standard t-tests for means, and Wilcoxon signed-ranks tests (WSR) for medians.

As shown in Panel A, the figures for the entire sample indicate that on average, the portfolio of reincorporating firms outperforms the size-matched comparison portfolio over all intervals. In the 2 years prior to their reincorporation, the sampled firms outperform the control portfolio by an average of 9.13% in year -2, and 12.68% in the year immediately preceding the domicile switch. Both are significant at the 5% level. This finding is similar to that of Dodd and Leftwich, who find CARs averaging 30% in the two

Table 9
Long-run capital market performance

The Table presents both mean and median size-decile adjusted holding period returns (HPRs) for the entire sample of firms (Panel A), for those firms whose managers cited motives consistent with contractual efficiency theories (Panel B), and for those firms with motives consistent with managerial entrenchment theories (Panel C). Size-decile adjusted HPRs are defined as the difference between each sample firm's return and the return on an equally-weighted portfolio of firms traded on the same exchange and with similar equity capitalization. Size-decile classifications were taken from the *CRSP* tapes and were updated annually. Tests of statistical significance are based on t-tests for means and Wilcoxon signed-ranks tests (WSR) for medians. (p-values in parentheses) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

		Size-Decile adjusted yearly HPRs — Year relative to reincorporation					
Panel A		-3	-2	-1	1	2	3
Entire Sample	mean	3 82%	9 13% **	12 68% **	4 29%	2 32%	0 61%
	p-value	(332)	(015)	(022)	(155)	(487)	(851)
	median	-7 14%	-0 94%	-1 39%	-6 81%	-4 54%	-7 11% **
	p-value (WSR)	(146)	(450)	(446)	(532)	(226)	(036)
	%>0	43%	49%	49%	44%	46%	42%
	N	269	309	335	346	330	304
Panel B	*Motives consistent with contractual efficiency theories*						
Liability reduction motives only	mean	-6 13%	3 12%	-0 01%	4 35%	5 82%	4 78%
	p-value	(456)	(610)	(999)	(623)	(487)	(629)
	median	-26 04% **	-0 85%	-4 71%	-8 90%	-4 59%	-6 36%
	p-value (WSR)	(043)	(960)	(279)	(213)	(607)	(310)
	%>0	31%	48%	42%	40%	46%	42%
	N	48	58	62	68	65	60
Flexibility/predictability motives only	mean	6 64%	36 59% **	15 31%	-2 51%	22 36%	2 05%
	p-value	(756)	(028)	(474)	(822)	(277)	(878)
	median	-20 07%	27 52% **	-18 13%	-14 59%	14 98%	-20 64%
	p-value (WSR)	(758)	(041)	(926)	(267)	(724)	(350)
	%>0	38%	65%	41%	41%	56%	32%
	N	26	26	27	27	25	22
Tax or fee reduction motives only	mean	15 56%	39 38% *	-13 25% *	-13 41%	59 82%	10 43%
	p-value	(322)	(096)	(100)	(167)	(198)	(508)
	median	18 39%	21 14%	-16 97% *	-21 94%	25 47%	-1 16%
	p-value (WSR)	(375)	(176)	(100)	(216)	(206)	(831)
	%>0	60%	75%	31%	38%	64%	45%
	N	10	12	13	13	11	11
All firms mentioning only contractual efficiency motives	mean	-0 66%	17 17% **	3 99%	0 07%	9 01%	5 70%
	p-value	(982)	(017)	(434)	(988)	(206)	(359)
	median	-22 32% *	6 19%	-4 60%	-9 61% *	-6 62%	-6 92%
	p-value (WSR)	(093)	(134)	(604)	(055)	(603)	(343)
	%>0	37%	54%	45%	42%	45%	42%
	N	109	127	137	139	132	118
Panel C	*Motives consistent with managerial entrenchment theories*						
Antitakeover motives only	mean	10 38%	-1 97%	12 02%	6 94%	-3 82%	-3 36%
	p-value	(243)	(665)	(140)	(257)	(535)	(549)
	median	1 56%	-6 29%	12 86%	13 90%	-5 16%	-5 01%
	p-value (WSR)	(773)	(374)	(137)	(175)	(432)	(441)
	%>0	52%	45%	60%	57%	38%	43%
	N	42	47	48	47	45	42
All firms with entrenchment motives[a]	mean	8 85%	-0 12%	15 25% **	1 58%	-1 67%	-3 13%
	p-value	(246)	(976)	(045)	(731)	(754)	(561)
	median	-0 35%	-3 42%	8 89%	-6 37%	-4 03%	-5 01%
	p-value (WSR)	(994)	(625)	(110)	(702)	(520)	(293)
	%>0	50%	45%	56%	45%	44%	42%
	N	60	64	66	66	63	60

a Represents all firms that cited solely antitakeover motives or faced capital market pressures in the year prior to reincorporation

b None of the sample firms mentioned acquisition motives as the sole reason for reincorporation

c Since only two firms mentioned domicile reasons as the sole reason for reincorporation, their results are not presented

d Reincorporations occurring in 1991 and 1992 (23 in total) are not represented in year 3, and years 2 and 3 due to data restrictions year period prior to reincorporation for their earlier sample of reincorporating firms Although mean performance exceeds that of the control portfolio, the median performance of the sampled firms lags behind that of the control portfolios for all periods. The Wilcoxon signed-ranks test (WSR) indicates that the median level of size-decile adjusted performance of -7.11% in year 3 is significantly lower than that of the control portfolios at the 5% level. Overall, while the portfolio of reincorporating firms outperforms its size-matched portfolio, the difference between mean and median adjusted performance suggests that this result is due to the exceptional performance of a few firms.

Panel B presents the corresponding figures for those firms whose managers cited reincorporation motives that are consistent with contractual efficiency arguments. Similar to the results for the entire sample, the mean adjusted performance levels for those firms citing solely director liability reduction motives are much higher than are the medians. With the exception of the -26.04% median level of size-adjusted performance in year -3, the capital market performance for these firms does not significantly differ from the benchmark portfolio over the period analyzed.

There is no significant trend in the capital market performance of those firms citing only flexibility or predictability motives for reincorporation. In year -2, these firms outperformed the control portfolio by an average of 36.59% (median = 27.52%). Both are significant at the 5% level.

Although there is no specific pattern to the capital market performance of firms in the tax/fee reduction category, these firms tended to underperform their control portfolio in the year preceding and the year after reincorporation. In the year prior to reincorporation, the mean level of underperformance of -13.25% and the corresponding median level of -16.97% statistically differ from zero at the 10% level. Although this underperformance persisted in the year after the reincorporation (mean = -13.41%, median = -21.94%), these figures are not significant at conventional levels.

Perhaps the most prevalent trend in the capital market performance of the entire set of firms that reincorporated for contractual efficiency reasons is that the mean levels of capital market performance are predominantly positive (significant in year -2), while the median levels are predominantly negative (significant in years -3 and +1). This implies that while the majority of these firms underperformed slightly in capital markets, an equally-weighted portfolio of these firms performed at least as well as expected as a result of the superior performance of a few firms.

The final set of capital market performance figures, presented in Panel C, are those for the collection of firms with express or implied reincorporation motives that are consistent with managerial entrenchment theories. As is shown in the Panel, there is no evidence of subpar capital market performance for these firms. In fact, those firms that cited solely antitakeover motives outperformed the control portfolio in the years preceding and subsequent to reincorporation by an average of 12.02% and 6.94% respectively, although neither the mean nor median levels of abnormal performance are significant at conventional levels. A similar trend exists in the returns for the entire set of firms with apparent entrenchment motives. The mean level of capital market performance for the collection of firms with entrenchment motives in the year prior to their reincorporation exceeds that of the benchmark portfolio by 15.25% (significant at the 5% level). In years

2 and 3, the market performance for both sets of firms in Panel C declines somewhat to a level below that of the size-matched portfolio, although both mean and median differences are insignificant. These results suggest that on average, firms that reincorporated for defensive reasons did not do so in the presence of sub-par capital market performance.

In sum, with the exception of those firms that cited tax or fee reduction motives, the analysis of capital market performance presented in Table 9 suggests that those firms which reincorporated between 1980 and 1992 did so following a period of exceptional capital market performance. Interestingly, the portfolio of those firms that reincorporated for reasons consistent with managerial entrenchment theories performed marginally better than its benchmark portfolio in the periods leading up to, and immediately following their reincorporations. This suggests that the defensive actions taken by the managers of these firms were not motivated by the potential for takeover threats arising out of disciplinary reasons. Although these firms tended to later underperform their size-matched counterparts in years 2 and 3, the magnitude of this underperformance does not statistically differ from zero.

9.2.2 *Operating performance of reincorporating firms*

As discussed in chapter 8, the ratio of OIBD/TA is used to measure operating performance. The median levels of OIBD/TA for all firms in the same industry (4-digit SIC code) as the sample firms are used as the benchmark performance measures for each firm. The average number of firms used to determine industry benchmarks is 33 (min = 3, max = 239).

Table 10 presents the results of the operating performance tests. The figures in the Table are presented in a similar fashion as the capital market performance figures in Table 9. That is, Panel A presents the results for the entire sample, Panel B provides the results for those firms whose managers cited reincorporation motives consistent with contractual efficiency theories, and Panel C presents the corresponding figures for those firms with express or implied motives that are consistent with managerial entrenchment theories. Tests of statistical significance are based upon standard t-tests for means, and Wilcoxon signed-ranks tests (WSR) for medians.

As is evident in Panel A, the operating performance measures for the entire sample are qualitatively similar to the performance of those firms in the same industry, both prior to, and immediately following the reincorporations. However, in both the second and third fiscal years after the reincorporation, operating performance measures decline somewhat to levels that are significantly below the comparable industry figures. In year 3, both the mean OIBD/TA ratio of .100 and the median ratio of .106 are significantly lower than the industry average of .115 at the 1% and 5% levels of significance. A similar trend, although less pronounced, was also found in the capital market performance measure for year 3 (as depicted in Table 9).

Panel B presents the results for those sets of firms with reincorporation motives more consistent with contractual efficiency arguments. For those firms that cited solely director liability reduction motives, both mean and median levels of operating performance lag their industry benchmarks from the year of reincorporation onward. In the year of the reincorporation, the mean OIBD/TA ratio of .078 and the median ratio of .087 are

Table 10
Operating performance of reincorporating firms

The Table presents both the mean and median levels of operating income as a fraction of total assets (OIBD/TA) and for the purpose of comparison, the average of comparable industry figures. For each sample firm, comparable industry figures are defined as the median OIBD/TA ratio for all firms in the same 4-digit SIC classification. Panel A presents figures for the entire sample, Panel B presents the figures for those firms whose managers cited motives that are consistent with contractual efficiency theories, and Panel C presents the figures for those firms with motives consistent with managerial entrenchment theories. Tests of statistical significance are based on t-tests for mean industry adjusted figures and Wilcoxon signed-ranks tests for median differences. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

		Year relative to reincorporation						
Panel A		-3	-2	-1	0	1	2	3
Entire Sample	Mean OIBD/TA	0.129	0.112	0.116	0.111	0.109	0.104 *	0.100 ***
	Median OIBD/TA	0.129	0.123	0.119	0.116	0.117	0.117	0.106 **
	Industry average	0.126	0.119	0.116	0.114	0.118	0.114	0.115
	(p-value)	(.602)	(.209)	(.905)	(.440)	(.107)	(.058)	(.003)
	[p-value (WSR)]	[.355]	[.546]	[.341]	[.771]	[.331]	[.441]	[.044]
	N	298	319	330	340	327	314	294
Panel B	*Motives consistent with contractual efficiency theories*							
Liability reduction motives only	Mean OIBD/TA	0.125	0.107	0.091	0.078 **	0.100	0.080 **	0.097
	Median OIBD/TA	0.119	0.110	0.105	0.087 *	0.101	0.099	0.098
	Industry average	0.121	0.100	0.104	0.106	0.104	0.107	0.113
	(p-value)	(.760)	(.586)	(.315)	(.033)	(.733)	(.038)	(.127)
	[p-value (WSR)]	[.678]	[.856]	[.374]	[.079]	[.499]	[.105]	[.297]
	N	54	57	62	64	59	58	56
Flexibility/predictability motives only	Mean OIBD/TA	0.111	0.118	0.128	0.131	0.102	0.076	0.070 **
	Median OIBD/TA	0.113	0.105	0.107	0.122	0.113	0.085	0.086 **
	Industry average	0.127	0.119	0.113	0.108	0.107	0.101	0.109
	(p-value)	(.373)	(.944)	(.439)	(.142)	(.720)	(.128)	(.034)
	[p-value (WSR)]	[.592]	[.963]	[.496]	[.268]	[.931]	[.112]	[.040]
	N	22	23	24	26	26	23	21
Tax or fee reduction motives only	Mean OIBD/TA	0.063 **	0.061 ***	0.094	0.077 *	0.088 *	0.099	0.113
	Median OIBD/TA	0.060 **	0.075 ***	0.093 *	0.074 *	0.078 *	0.104	0.112
	Industry average	0.107	0.114	0.123	0.104	0.122	0.128	0.123
	(p-value)	(.028)	(.001)	(.172)	(.092)	(.061)	(.249)	(.646)
	[p-value (WSR)]	[.032]	[.002]	[.054]	[.083]	[.094]	[.175]	[.898]
	N	13	14	14	15	13	12	11
All firms that mentioned only contractual efficiency motives	Mean OIBD/TA	0.124	0.112	0.108	0.105	0.101 *	0.088 ***	0.092 ***
	Median OIBD/TA	0.121	0.119	0.114	0.107	0.104	0.103 ***	0.098 **
	Industry average	0.126	0.118	0.113	0.115	0.114	0.112	0.115
	(p-value)	(.806)	(.455)	(.521)	(.188)	(.093)	(.004)	(.003)
	[p-value (WSR)]	[.958]	[.258]	[.593]	[.407]	[.101]	[.009]	[.023]
	N	116	122	131	136	130	120	114
Panel C	*Motives consistent with managerial entrenchment theories*							
Antitakeover motives only	Mean OIBD/TA	0.152	0.127	0.115	0.118	0.118	0.122	0.113
	Median OIBD/TA	0.161	0.151	0.121	0.114	0.129	0.138	0.119
	Industry average	0.140	0.135	0.127	0.120	0.118	0.118	0.116
	(p-value)	(.386)	(.542)	(.420)	(.859)	(.948)	(.712)	(.756)
	[p-value (WSR)]	[.469]	[.914]	[.855]	[.951]	[.846]	[.432]	[.737]
	N	45	47	47	47	47	46	45
All firms with entrenchment motives[a]	Mean OIBD/TA	0.128	0.107	0.109	0.103	0.106	0.106	0.111
	Median OIBD/TA	0.130	0.117	0.112	0.106	0.120	0.132	0.111
	Industry average	0.133	0.125	0.126	0.118	0.118	0.115	0.116
	(p-value)	(.680)	(.109)	(.145)	(.177)	(.247)	(.432)	(.456)
	[p-value (WSR)]	[.813]	[.330]	[.355]	[.242]	[.335]	[.909]	[.378]
	N	62	65	65	65	64	63	60

a. Represents all firms that cited solely antitakeover motives or faced capital market pressures in the year prior to reincorporation.
b. None of the sample firms mentioned acquisition motives as the sole reason for reincorporation.
c. Since only two firms mentioned domicile-reconciliation reasons for reincorporation, their results are not presented here.
d. Reincorporations occurring in 1991 and 1992 (23 in total) are not represented in year 3, and years 2 and 3 due to data restrictions.

significantly lower than the industry averages of .106 at the 5% and 1% levels of significance.

With the exception of the third year after their reincorporation, the operating performance of those firms that cited solely flexibility or predictability motives does not materially differ from the industry benchmarks. In year 3, both the mean OIBD/TA ratio of .07 and the median ratio of .086 are significantly lower than the industry benchmark of .109 at the 5% level.

The operating performance of those firms that mentioned exclusively tax or fee reduction motives is significantly lower than would be expected for their industries for nearly all of the relative years examined. This is particularly the case in the years preceding the reincorporation and persists through year +1, after which operating performance levels do not significantly differ from their benchmarks. The pattern of poor operating performance for this set of firms is similar to that found in the analysis of capital market performance.

Interestingly, in the years subsequent to reincorporation, the operating performance for the entire set of firms that cited contractual efficiency motives declines to levels significantly below that of the comparable industry benchmarks. In the second and third years after the reincorporations, the mean [median] OIBD/TA ratios of .088 [.103] and .092 [.098] are significantly lower than the comparable industry levels of .112 and .115 respectively. This apparent decrease in the efficiency of asset utilization is somewhat perplexing given that the reincorporations of these firms were conducted in order to increase efficiency.

Panel C presents the results of the operating performance tests for those firms with express or implied reincorporation motives that are consistent with managerial entrenchment theories. As was the case with the capital market performance measures in Table 9, the operating performance measures for these firms compare favorably to those of the control firms over all periods. In no cases were either the mean or median levels of operating performance statistically different from the industry benchmarks. This finding once again reinforces the notion that on average, the defensive reincorporations of these firms do not appear to be motivated by poor-performance.

Viewed collectively, the tests of capital market performance and operating performance reveal three significant findings. First, the overall sample of reincorporating firms performs at least as well as would be expected. Prior to reincorporation, the capital market performance of the entire sample at the portfolio level exceeds that of the size-matched portfolio while operating performance measures are found to be qualitatively similar to industry benchmarks. Second, those firms that reincorporated for solely defensive reasons did not do so as a result of either poor capital market or operating performance. Finally, those firms that reincorporated in order to save on taxes or fees performed poorly in both capital markets and in operations in the years immediately prior to and immediately following their reincorporation. This poor performance is likely to be a primary factor in motivating the managers of these firms to undertake cost-reduction strategies which include lowering the magnitude of fees paid to chartering jurisdictions.

9.3 The relationships between firm attributes and reincorporation motives

The bulk of the literature presented in chapters 2 and 3 suggests that the choice of corporate chartering jurisdictions is a function of firm attributes. However, since there exists a wide diversity in the reincorporation motives that are cited by corporate managers, firms reincorporating for different reasons are likely to exhibit substantially different characteristics as well. The hypotheses presented in chapter 4 rely upon existing theories to develop predicted relationships between reincorporation motives and firm attributes. Those hypotheses are tested here using logistic regressions.

Palepu (1986) demonstrates the importance of using a large, non-random sample, or possibly the entire population of non-event firms at a given time, to avoid sample selection bias in logistic analyses of this nature. Therefore, for the following logistic regressions, I use the population of publicly-traded firms that are covered on both the *CRSP* tapes and the *COMPUSTAT* database for the year 1987 with sufficient information to compute the selected variables. The year of 1987 was chosen because of the large proportion of reincorporations (nearly 40% of the sample) that occurred in that year. 3712 firms met these data requirements and they represent the 'non-event' firms. A total of 293 of the sampled reincorporating firms met the same data requirements in the years surrounding their reincorporations and thus represent the 'event' firms. For the set of reincorporating firms, the base year used to compute the independent variables is the year of their reincorporations.[43] The total sample used for the logistic regressions therefore consists of 4005 (3712+293) firms.

The independent variables used in the logistic regressions represent proxies for those firm attributes that have been hypothesized to play an influential role in the decision to reincorporate. These variables are presented in Table 11. As shown in Table 11, the independent variables used encompass firm characteristics such as firm size, financial structure (debt ratio), ownership concentration (average shareholdings), sales growth, dividend payout rates, the investment opportunity set (market-to-book ratios), operating performance (OIBD/TA), R&D intensity, operations in technology intensive industries (technology dummy variable), and the state of incorporation.[44]

Prior to the estimation of the logistic regressions, univariate tests were conducted on the independent variables in order to identify the presence of extreme outliers that may have an influence on the test results. This process identified a few 'significant' outliers in those cases where ratios were computed. In order to minimize the influence of these significant outliers, yet maintain the informational content of each observation, in those cases where financial ratios were computed, computed ratios falling beyond the 1% and 99% levels of their overall distributions were set to the 1% and 99% levels respectively.

[43]This approach is similar to that used by Palepu (1986) in his analysis of takeover targets. Since the majority of independent variables are scaled by total assets, total sales, or are indicator variables, the results should not be sensitive to shifts in population characteristics over time.

[44]For the set of reincorporating firms, the state of exodus is used as the state of incorporation.

Table 11
Independent variables used in the estimation of logistic regressions of reincorporation likelihood

The Table provides the variable definitions for the independent variables used in estimating logistic regressions of reincorporation likelihood. Unless otherwise indicated, variables for the set of non-reincorporating firms have a base year of 1987. For reincorporating firms, the base year used is the year of the reincorporation.

Variable name	Definition	Construction
		#'s represent *COMPUSTAT* data items
Size	log of total assets	log (data item # 6)
Debt ratio	total debt / total assets = ltd + current liabilities / total assets	((data item #5 + data item # 9)/data item # 6) * 100
Average holdings	average number of shares held per common shareholder	data item #25 (common shares) / data item #100 (# of common holders)
Sales growth	2-year sales growth =(sales(yr) / sales(yr-2)) - 1	((data item # 12 (yr) / data item # 12 (yr-2))-1) * 100
Dividends[a]	proportion of sales revenue distributed as common dividends	(data item # 21 / data item # 12) * 100
Market-to-book	(market value of equity plus the book value of debt) / book value of total assets	data item's ((24*25)+9+5+(19/pref. yield))/ data item # 6
OIBD/TA	operating income before depreciation / book value of total assets	(data item # 13 / data item # 6) *100
R&D/TA	research and development expenses / book value of total assets	(data item # 46 / data item # 6) * 100
Technology	dummy variable indicating operations in technology intensive industries	= 1 if 3500 <= SIC <= 3700, or if 3800 <= SIC <= 3900, zero otherwise
California[b]	dummy variable indicating incorporation in California	=1 if the state of incorporation is California, zero otherwise[c]
Delaware[b]	dummy variable indicating incorporation in Delaware	=1 if the state of incorporation is Delaware, zero otherwise[c]
Other[b]	dummy variable indicating incorporation in states other than California or Delaware	= 1 if the state of incorporation is neither California nor Delaware, zero otherwise[c]

a. The variable representing dividends is scaled by total sales rather than net income because it is designed to capture the extent to which firms distribute internally generated cash. The use of net income as a denominator in this case would produce negative dividend payout ratios in those cases where firms pay dividends, but had a net loss for the year, thus, clouding the results. In contrast, the use of total sales as the denominator produces strictly positive payout ratios for those firms that pay dividends, with a lower bound of zero for those firms that do not pay dividends.

b. As specified, a maximum of 2 state of incorporation indicator variables may be used simultaneously.

c. In the case of reincorporating firms, the state indicator variables represent the state from which the firms reincorporated (i.e., the state of exodus).

9.3.1 *Attributes of firms reincorporating for antitakeover reasons*

Table 12 presents the results of the logistic regressions used to identify those attributes that play an influential role in prompting managers to reincorporate for antitakeover reasons. In models (i) and (ii), the dependent variable is 1 for those firms that reincorporated and cited antitakeover motives and zero otherwise. In models (iii) and (iv), the dependent variable is 1 for those firms that reincorporated and cited **solely** antitakeover motives and zero for all firms that did not reincorporate for antitakeover reasons. With a few exceptions, the results of the 4 estimated logistic regressions are substantially similar. Therefore, I will discuss the overall results simultaneously, identifying those attributes that show up as significant as well as highlighting the differences among the estimated models.

Hypothesis 7 in chapter 4 predicted that firms reincorporating for antitakeover reasons would be characterized by lower growth opportunities, higher potential agency costs, and poorer performance. The estimated logistic regressions found in Table 12 show that this is not the case. Rather, the significantly positive coefficients on the market-to-book ratio (in all models) and the positive coefficients on the operating performance variable (OIBD/TA) suggest that these firms tend to have higher growth opportunities (and thus, a lower potential for agency conflicts such as overinvestment, etc.) and tend to be performing well (as proxied by OIBD/TA). A similar conclusion on the performance for this set of firms was drawn from the results of capital market and operating performance tests presented in Tables 9 and 10. The significantly negative coefficients on

Table 12
Estimates of logit reincorporation likelihood models
Managerial entrenchment (antitakeover) motives

Models (i) and (ii) present the estimates of logistic regressions where the dependent variable is one for publicly traded firms that reincorporated and cited antitakeover motives as a factor in the decision to reincorporate and zero otherwise. Models (iii) and (iv) present the estimates of logistic regressions where the dependent variable is one if a firm reincorporated and firm managers mentioned solely antitakeover motives for the reincorporation and zero for all other firms that did not reincorporate for antitakeover reasons. (p-values) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

	Reincorporations including antitakeover motives		Reincorporations with solely antitakeover motives	
Variable	model (i)	model (ii)	model (iii)	model (iv)
Intercept	-3.9819 ***	-4.9065 ***	-5.3871 ***	-8.9987 ***
	(.0001)	(.0001)	(.0001)	(.0001)
Size	0.0599	0.1267 ***	0.1911 **	0.3356 ***
	(.1379)	(.0046)	(.0181)	(.0003)
Debt ratio	-0.0009	0.0031	-0.0047	-0.0014
	(.8066)	(.4579)	(.5610)	(.8658)
Average holdings	-0.0219 *	-0.0483 ***	-0.0929 **	-0.1233 ***
	(.0645)	(.0017)	(.0316)	(.0079)
Sales growth	0.0008	0.0007	-0.0012	-0.0019
	(.2822)	(.3781)	(.5437)	(.4142)
Dividend payout	-0.0519 *	-0.0548 **	-0.2759 **	-0.3142 ***
	(.0747)	(.0396)	(.0296)	(.0097)
Market-to-book	0.3161 ***	0.3418 ***	0.5312 ***	0.5718 ***
	(.0005)	(.0009)	(.0027)	(.0066)
OIBD/TA	0.0157 **	0.0180 **	0.0134	0.0173
	(.0182)	(.0161)	(.3413)	(.3082)
R&D/TA	0.0234 **	-0.0001	0.0154	-0.0192
	(.0280)	(.9936)	(.5486)	(.5946)
Technology	0.4042 **	0.1324	-0.3157	-0.8823 **
	(.0255)	(.5211)	(.4522)	(.0674)
California		3.0375 ***		5.9006 ***
		(.0001)		(.0001)
Model χ^2 statistic	50.853 ***	304.079 ***	26.154 ***	148.892 ***
	(.0001)	(.0001)	(.0019)	(.0001)
Pseudo-R^2 a	.04	.22	.06	.32
N	4005	4005	3876	3876

a. Pseudo-R^2 is similar to that of R^2 in multiple regression. It is a measure of how well the model fits the data. It is calculated as 1-(log likelihood at convergence / log likelihood at zero).

b. Independent variables are defined in Table 11.

the dividend payout measures in all four models suggest that these firms are less likely to pay dividends than is the typical firm. This finding, coupled with the significantly positive coefficient on the market-to-book variable, suggests these firms are in a growth stage, in which they rely heavily upon internally generated funds, and possibly upon a substantial amount of external financing to fund investment opportunities.

The positive coefficients on the size variable (significant in 3 models) show that firms reincorporating for antitakeover reasons tend to be larger firms with smaller average shareholdings. This implies that as ownership becomes more dispersed (due to equity offerings, etc.), managers are more compelled to erect takeover barriers to offset their increased exposure to takeover threats. When the existing state of incorporation does not support or provide such measures, firms exhibiting more dispersed ownership are more likely to reincorporate into another jurisdiction in order to reduce their susceptibility to unsolicited takeover attempts. Perhaps the most convincing support for this explanation is provided by the highly significant positive coefficients on the California dummy variable in models (ii) and (iv). The magnitude of these positive coefficients suggest the managers of California incorporated firms having somewhat dispersed ownership did not feel that they could adequately protect themselves from unsolicited takeover attempts under the California corporate code. These concerns appear to be a primary factor in their decision to relocate elsewhere. This fact is corroborated by the figures provided in Table 3, which illustrate that a disproportionately high frequency of reincorporations for antitakeover reasons involved an exodus from the state of California. Further evidence in this regard is shown by the substantial increase in the explanatory power of the logistic regressions attributable solely to the inclusion of the California dummy variable. The inclusion of the California dummy increased the explanatory power (as proxied by pseudo-R^2) from .04 to .22 from model (i) to model (ii), and even further from .06 to .32 from model (iii) to model (iv).

There are two cases where the coefficients on the independent variables differ, or change when alternative models are estimated. Model (ii) is the same as model (i) with the exception that model (ii) contains the California dummy variable. In the absence of this variable, (i.e., in model (i)), both the R&D construct and the technology dummy variable have significantly positive coefficients. This is perhaps due to the fact that many of the high-technology firms that reincorporated in order to take advantage of director liability reduction provisions in Delaware's corporate law also adopted antitakeover measures upon reincorporating. Supporting evidence can be found in Table 6 of chapter 7. Table 7 documents a high frequency of antitakeover charter amendments coinciding with reincorporation plans that include director liability reduction motives. When the California dummy variable is included in model (ii), the significance of the R&D construct and the technology dummy variable disappears. This result suggests that the state of California once harbored, but also lost a disproportionate share of technology oriented and R&D intensive firms to other states during the studied period. Finally, the negative coefficients on the technology dummy variable in models (iii) and (iv) are in contrast to the positive coefficients in models (i) and (ii). This contrast in signs has a rather straightforward interpretation -- many high-technology firms cited multiple reasons for reincorporation, often including antitakeover motives, however, firms in technology intensive industries rarely incorporated for exclusively antitakeover purposes.

9.3.2 *Attributes of firms reincorporating to reduce director and officer liability*

Table 13 provides the results of the logistic regressions employed to identify those firm attributes that play a significant role in motivating managers to reincorporate the firm in order to reduce director liability. The Table presents the results in a similar manner as those provided in Table 12 for firms citing antitakeover motives. That is, models (i) and (ii) are estimated to contrast the entire set of firms that reincorporated for director liability reduction motives with all firms that did not reincorporate for these purposes, while in models (iii) and (iv), the dependent variable is 1 for those firms that cited **solely** director liability reduction motives for reincorporation and zero for all firms that did not reincorporate for director liability reasons.

Hypothesis 6 in chapter 4 predicted that firms reincorporating for director liability reduction reasons would exhibit characteristics that increase their vulnerability, or alternatively, their likelihood of involvement in, shareholder litigation. Such characteristics are likely to include technology intensive operations and/or poorer performance.[46] Since these types of firms are more vulnerable to threats arising out of

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[46]An informative discussion on the vulnerability of high-technology firms to shareholder lawsuits can be found in the *Wall Street Journal* (April 5, 1994) in an article titled "Small Fast-Growth Firms Feel Chill of Shareholder Suits". With regard to performance, Brook and Rao (1994) provide evidence that poorly performing firms benefit from provisions that limit director liability and suggest that since poorly performing firms are more likely to be

Table 13
Estimates of logit reincorporation likelihood models
Director liability reduction motives

Models (i) and (ii) present the estimates of logistic regressions where the dependent variable is one for publicly traded firms that reincorporated and director liability reduction motives as a factor in the decision to reincorporate and zero otherwise. Models (iii) and (iv) present the estimates of logistic regressions where the dependent variable is one if a firm reincorporated and firm managers mentioned solely director liability reduction motives for the reincorporation and zero for all other firms that did not reincorporate for these reasons. (p-values) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

	Reincorporations including director liability reduction motives		Reincorporations with solely director liability reduction motives	
Variable	model (i)	model (ii)	model (iii)	model (iv)
Intercept	-3.4849 ***	-4.3438 ***	-4.8399 ***	-5.8076 ***
	(.0001)	(.0001)	(.0001)	(.0001)
Size	0.0200	0.0502	0.1615 **	0.2049 **
	(.6676)	(.3338)	(.0420)	(.0202)
Debt ratio	-0.0079 *	-0.0032	-0.0222 ***	-0.0174 **
	(.0536)	(.4570)	(.0056)	(.0346)
Average holdings	-0.0055	-0.0201 *	-0.0134	-0.0328
	(.5097)	(.0963)	(.4186)	(.1601)
Sales growth	0.0009	0.0009	0.0004	0.0003
	(.1964)	(.2552)	(.7895)	(.8325)
Dividend payout	-0.2895 ***	-0.2172 ***	-0.8273 ***	-0.6842 **
	(.0010)	(.0078)	(.0023)	(.0143)
Market-to-book	0.1680 *	0.1679	0.2924 *	0.3166 *
	(.0789)	(.1249)	(.0507)	(.0621)
OIBD/TA	0.0119 *	0.0122 *	-0.0049	-0.0089
	(.0551)	(.0766)	(.6126)	(.3965)
R&D/TA	0.0301 **	0.0083	0.0235	-0.0032
	(.0024)	(.5156)	(.1853)	(.8952)
Technology	0.7164 ***	0.4785 **	1.1279 ***	6.8445 **
	(.0001)	(.0143)	(.0001)	(.0101)
California		3.0428 ***		3.2387 ***
		(.0001)		(.0001)
Model χ^2 statistic	90.581 ***	358.027 ***	67.343 ***	175.196 ***
	(.0001)	(.0001)	(.0001)	(.0001)
Pseudo-R^2 [a]	.07	.26	.12	.30
N	4005	4005	3893	3893

a. Pseudo-R^2 is similar to that of R^2 in multiple regression. It is a measure of how well the model fits the data. It is calculated as 1-(log likelihood at convergence / log likelihood at zero).

b. Independent variables are defined in Table 11.

shareholder litigation, they are more likely to actively pursue strategies to curtail liability exposure.

The results shown in Table 13 are consistent with the conjecture that high technology firms are more likely to reincorporate for director liability reduction reasons. In all of the estimated models, the coefficient on the technology dummy variable is positive and significant. In addition, the coefficient on the R&D intensity measure is predominantly positive in the estimations and is significant in model (i). However, there is only limited support for the conjecture that poorly performing firms may be motivated to reincorporate for director liability reduction purposes. In fact, the signs on the operating performance variable (OIBD/TA) are positive and significant for the entire set of firms that cited director liability reduction motives. However, in models (iii) and (iv), which are estimated for those firms that cited solely director liability reduction motives, the signs on the operating performance measure are negative, although not significant. This finding is similar to the result of the tests of operating performance presented in Table 10. Collectively, the lack of an overall trend of underperformance for this set of firms in capital markets (Table 9), in operations (Table 10) and the positive and significant coefficients on the market-to-book variable in models (i), (iii), and (iv), suggest that reincorporations for these purposes are neither motivated by, nor indicative of, poor performance.

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involved in litigation, such measures improve the ability of such firms to attract and retain expert decisionmakers.

The coefficients on the variables used to capture financing characteristics are consistent with theories of capital structure regarding the financing of high-technology firms. Specifically, the coefficients on the debt ratio are negative and significant in models (i), (iii), and (iv), while the coefficient on the dividend payout measure is negative and significant in all of the estimated models. This implies that growth-oriented high technology firms rely heavily upon internally generated funds and equity financing rather than debt financing because of the intangible nature of their assets and the volatility of cash flows. As suggested earlier, these characteristics (high-technology, equity financing, and volatility) also lead to a heightened potential for shareholder litigation arising out of informational asymmetries between shareholders and managers. Such asymmetries give rise to a disproportionate amount of shareholder lawsuits against high-technology firms, resulting in increased legal costs, higher D&O insurance premiums, and ultimately, higher levels of risk borne by managers.

Finally, as was the case in the logistic regressions estimated for those firms that cited antitakeover motives, the California dummy variable is highly significant and its inclusion in models (ii) and (iv) significantly increases the explanatory power of the models. The explanatory power of the California dummy variable in both Table 12 and here in Table 13 illustrates the dynamics of the competition in the market for corporate charters. Specifically, managers are attracted to chartering jurisdictions where they can decrease their financial exposure to outside threats. During the mid-1980s, a substantial proportion of the high-technology firms that were adversely affected by the crisis in the market for D&O liability insurance were incorporated in California. The state of Delaware modified its corporate law in 1986 to allow for charter amendments to limit director liability, and in doing so, provided managers with a means to contract much of these costs and risks away. States such as California that were slow to introduce similar legislation to curtail these threats faced by corporate decisionmakers lost a large number of corporate charters for this reason.

9.3.3 *Attributes of firms reincorporating for non-defensive (contractual efficiency) reasons or with tax/fee reduction motives*

Table 14 presents the remaining logistic regressions for those firms that reincorporated for non-defensive (i.e., contractual efficiency) reasons. Models (i) and (ii) are estimated with the dependent variable set to 1 if a firm reincorporated and did not cite either antitakeover or tax or fee reduction motives. Otherwise, the dependent variable is set to zero. The regressions on this set of firms are designed to test hypothesis 3 of chapter 4. Models (iii) and (iv) are estimated to identify those firm attributes that may influence managers to reincorporate in order to reduce taxes or fees. In these two models, the dependent variable is one if the firm reincorporated and cited tax or fee reduction motives and zero for all firms that did not reincorporate for these reasons.

Hypothesis 3 (chapter 4) predicted that firms that reincorporate for non-defensive reasons other than tax or fee reduction are in general, growing firms that exhibit characteristics consistent with a high demand for external financing. This hypothesis was derived out of the contractual efficiency theories discussed in chapters 2 and 3, which suggest that the choice to move to a more liberal jurisdiction is made when firms become

Table 14
Estimates of logit reincorporation likelihood models
Non-defensive (contractual efficiency) reasons and tax/fee reduction motives

Models (i) and (ii) present the estimates of logistic regressions where the dependent variable is one for publicly traded firms that reincorporated and did not cite either antitakeover or tax/fee reduction motives, and zero otherwise. Models (iii) and (iv) present the estimates of logistic regressions where the dependent variable is one if a firm reincorporated and firm managers mentioned tax or fee reduction motives for the reincorporation and zero for all other firms that did not reincorporate for these reasons. (p-values) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

	Reincorporations for non-defensive and non-tax related reasons		Reincorporations with tax/fee reduction motives	
Variable	model (i)	model (ii)	model (iii)	model (iv)
Intercept	-4.0649 ***	-7.3057 ***	-4.9478 ***	-5.2064 ***
	(.0001)	(.0001)	(.0001)	(.0001)
Size	0.0915	0.1564 **	-0.0280	-0.0546
	(.1176)	(.0110)	(.7883)	(.6025)
Debt ratio	-0.0091 *	-0.0054	-0.0011	-0.0013
	(.0846)	(.3157)	(.9024)	(.8860)
Average holdings	-0.0176	-0.0257	-0.0078	-0.0105
	(.2120)	(.1269)	(.6824)	(.5964)
Sales growth	0.0013	0.0014	0.0025 **	0.0024 **
	(.1501)	(.1532)	(.0386)	(.0499)
Dividend payout	-0.4173 ***	-0.4465 ***	-0.0815	-0.0630
	(.0014)	(.0009)	(.3950)	(.4517)
Market-to-book	0.2027 *	0.2268 *	0.2834	0.2491
	(.0939)	(.0832)	(.1829)	(.2433)
OIBD/TA	0.0049	0.0015	-0.0009	-0.0025
	(.5343)	(.8630)	(.9465)	(.8695)
R&D/TA	0.0201	0.0014	-0.1449	-0.1390
	(.1374)	(.9372)	(.1139)	(.1278)
Technology	0.5505 **	0.3361	-0.1014	-0.0837
	(.0138)	(.1632)	(.8683)	(.8903)
California		4.7111 ***		
		(.0001)		
Delaware				0.8377 **
				(.0343)
Other		3.1583 ***		
		(.0001)		
Model χ^2 statistic	49.484	177.164	12.815	17.423 *
	(.0001)	(.0001)	(.1711)	(.0655)
Pseudo-R^2 a	.05	.19	.04	.05
N	4005	4005	4005	4005

a. Pseudo-R^2 is similar to that of R^2 in multiple regression. It is a measure of how well the model fits the data. It is calculated as 1-(log likelihood at convergence / log likelihood at zero).

b. Independent variables are defined in Table 11.

larger and ownership becomes more dispersed. As is shown in models (i) and (ii) of Table 14, firms that reincorporated for these reasons tend to have somewhat higher levels of sales growth, significantly higher market-to-book ratios (a proxy for growth opportunities) and significantly lower dividend payout rates than the typical firm. This finding provides support for hypothesis 3. As was the case in the earlier logistic regressions, the inclusion of the state dummy variables substantially increases the explanatory power of the model, and once again illustrates the dominance of Delaware as the preferred chartering jurisdiction. While both the California dummy and the OTHER dummy variable (indicating incorporation in states other than California and Delaware) are statistically significant, within sample logistic regressions (shown in Appendix B) corroborate the evidence presented in Table 3, which reveals a significant trend in the migration patterns of the firms that cited contractual efficiency motives. Specifically, those firms that reincorporated for director liability reasons tended to migrate to Delaware from California, whereas the preponderance of reincorporations for contractual efficiency motives other than director liability reasons were to Delaware from chartering jurisdictions other than California.

Hypothesis 5 in chapter 4 predicts that firms that reincorporate for tax or fee reduction reasons generally reincorporate out of Delaware because they are smaller in size and do not substantially benefit from the Delaware code since it is tailored toward larger corporations with dispersed ownership. Therefore, firms of this type may not be able to justify the large chartering fees imposed on public firms incorporated in that state.[47] This

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conjecture is based on the arguments of Posner and Scott (1980) and Baysinger and Butler (1985). The tests conducted and presented in models (iii) and (iv) of Table 14 provide somewhat limited support for this hypothesis. In both models, the coefficient on the size variable is negative (as predicted), but not statistically significant. The coefficient on the operating performance measure (OIBD/TA) is negative, and thus is consistent with the findings of subpar capital market and operating performance for the set of firms that cited **solely** tax or fee reduction motives in Tables 9 and 10. However, the insignificance of this variable in the models here implies that poor-performance is not likely to be a significant factor in the decision for the **overall** set of firms to reincorporate for these reasons. The only variable that enters the estimations as significant is the sales growth measure, which is significantly positive, and the Delaware dummy variable (model (iv)), which is also positive and significant. Collectively, these results provide weak support for the hypothesis. The low explanatory power of both models (iii) and (iv) suggest that firms that reincorporate for tax or fee reduction purposes are difficult to identify based on their attributes.

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[47]One of the drawbacks of incorporation in Delaware is that Delaware charges public corporations significantly more than most other states in yearly chartering fees. The exact fee depends on firm size and capitalization until a threshold is surpassed, at which point the annual fee is capped at $150,000. An example of the relatively excessive premiums charged by the state of Delaware is provided in a *Wall Street Journal* article (October 21, 1993) concerning Microsoft's reincorporation to its home state of Washington. While the main reason given for the reincorporation was the recent amendment of Washington's law to better address director liability concerns, a secondary reason was the yearly savings in charter fees. The move to Washington reduced annual charter fees from $150,000 down to $59.

9.4 Cross-sectional analysis of abnormal returns surrounding and at the passage of reincorporations conducted for antitakeover purposes and director liability reduction reasons

The previous empirical tests reveal (i) that the market's reaction to a reincorporation is dependent upon the motives cited for the decision and (ii) that significant relationships exist between firm attributes and stated motives. However, in isolation, those tests may not fully capture all of the relationships between individual firm characteristics and the market reaction to the decision. Cross-sectional regression analyses are employed here to further examine the relations between abnormal returns and various firm attributes (e.g., financial, operating, and ownership characteristics). Since the preceding event-day analysis identified significant abnormal returns to the shareholders of those firms that cited either antitakeover motives (negative abnormal returns) and director liability reduction motives (positive abnormal returns), the cross-sectional analyses are conducted on these two sets of firms.

As discussed in section 9.1, reincorporations are rarely announced in the business press in advance of when proxy materials are mailed to shareholders. Rather, the majority of press announcements coincide with the date of shareholder approval. In Table 8, I presented the results of the event-day analysis surrounding both the earliest identified announcement date (in most cases (93.7%), this is the proxy mailing date) and the date of shareholder approval. In both cases, abnormal returns on the event days (day 0), as well as CARs over the 4-day interval (0,3) surrounding the event are presented. The 4-day CARs are particularly important in the case of the proxy mailing date, where it is unlikely that all shareholders will either receive the proxy materials, or form an opinion on them concurrently. Thus, the security price reactions surrounding the proxy mailing date are more likely to contain additional noise. The figures in Table 8 show that this is indeed the case, as the majority of the security price reactions to these decisions occur at the time when they are passed by shareholders. Since there is obviously information conveyed in the market's reaction in both the window surrounding the proxy mailing date and at the time of shareholder approval, in the following cross-sectional regressions, two alternative dependent variables are used. First, since the majority of the stock price reactions are detected on the day of plan passage, the abnormal returns for this day (t=0) are used as the dependent variables in model (i) in both of the following Tables (Tables 15 and 16). In model (ii), the dependent variable is defined as the sum of 4-day CARs surrounding the proxy mailing date, **and** the abnormal returns at the passage of these plans (t=0). In discussing the results of the cross-sectional analyses, I will place particular emphasis on the results in model (i) because of the greater magnitude of abnormal returns at the time when reincorporation plans are passed.

9.4.1 *Antitakeover motives, firm attributes, and shareholder wealth*

The discussion of antitakeover motives in section 6.2.1 of chapter 6 identified several firm attributes that have been hypothesized to likely play a material role in the market reactions to antitakeover measures, and thus reincorporations for antitakeover purposes. Such attributes include firm performance, the nature of operations (such as R&D intensity), ownership structure, and whether or not the firm is 'in play' at the time of the reincorporation. Further, since the sampled firms erect a variety of different takeover barriers (as shown in chapter 7, Table 6), it is likely that the market reactions will differ somewhat according to the type of defensive provisions as well.

Table 15 presents the results of the cross-sectional analysis of abnormal returns for the set of firms that cited antitakeover motives and met the requirements for inclusion in the event day analysis.[48] The independent variables are presented so that firm size and ownership characteristics are found in the upper portion of the Table, financial and operating characteristics are in the middle portion, and the nature of the control provisions adopted are in the lower portion. Contrasting the two estimating models shows that model (i) captures a much larger portion of the abnormal returns to these plans. The intercept in model (i) is negative but not significant, while the intercept in model (ii) is significantly negative, and reflects a much lower overall portion of the abnormal returns that are accounted for in model (ii). The adjusted R^2 measure corroborates this finding, and reveals that model (i) accounts for over twice the amount of cross-sectional return variability as model (ii). For this reason, and the reasons discussed earlier, I will place emphasis on the results of model (i).

The significantly positive coefficient on the liability dummy variable suggests that *ceteris paribus*, when director liability reduction motives are also cited, abnormal returns at the passage of the reincorporation proposal are 0.91% higher than when only antitakeover motives are mentioned. None of the variables capturing ownership

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[48]These requirements are discussed in section 9.1.

Table 15

Cross-sectional regressions of abnormal returns for reincorporations conducted with antitakeover motives

The Table presents OLS regressions of the abnormal returns for those firms which reincorporated for antitakeover reasons. The dependent variable in model (i) is the abnormal returns at the passage of these reincorporation plans. In model (ii), the dependent variable is the sum of the 4-day cumulative abnormal returns (CARs) for the interval (0,3) surrounding the earlier of the press announcement or the proxy mailing date and the abnormal return at the passage of the reincorporation plan. Market model parameters are estimat... over the period -250 to -51 prior to the event. (t-statistics are presented below parameter estimates in parentheses) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

	Dependent variable = Abnormal return at the passage of the plan of reincorporation	Dependent variable = CARs (0,3) at the proxy mailing date + abnormal return at passage
Variable	**model (i)**	**model (ii)**
Intercept	-0.01058 (-0.810)	-0.04939 ** (-1.999)
Size (log of assets)	0.00006 (0.028)	0.00336 (0.864)
Liability dummy	0.00911 * (1.840)	0.00354 (0.379)
Inside ownership %	-0.00003 (-0.198)	0.00062 * (1.959)
Non-management blockholder %	-0.00017 (-0.687)	0.00084 * (1.813)
Institutional ownership %	-0.00008 (-0.460)	-0.00027 (-0.825)
Debt ratio	0.00003 (0.215)	-0.00023 (-0.993)
Market-to-book ratio	-0.00174 (-0.601)	0.00647 (1.184)
Excess return (yr -1)[a]	-0.00012 ** (-2.480)	-0.00023 ** (-2.492)
OIBD/TA[b]	0.00081 *** (3.517)	0.00003 (0.063)
R&D expenditures / total assets	0.00169 *** (3.452)	0.00166 * (1.794)
Eliminated cumulative voting[c]	-0.00138 (-0.293)	-0.00306 (-0.344)
Classified board[c]	-0.00059 (-0.113)	0.01059 (1.066)
Supermajority / fair price amendment[c]	-0.00419 (-0.769)	-0.00057 (-0.055)
Blank check preferred stock[c]	-0.00911 (-1.493)	-0.02848 ** (-2.472)
Dual-class recapitalization[c]	0.00962 (0.692)	0.01632 (0.621)
Business combination restrictions[c]	-0.00209 (-0.291)	0.01524 (1.123)
In play[d]	-0.02385 *** (-2.661)	-0.00258 (-0.152)
N	161	161
R^2	.2769	.1784
Adjusted R^2	.1916	.0814

a. Size-decile adjusted returns for the 12 months prior to the reincorporation. (further information is provided in section 8.2.1)
b. For the fiscal year of the reincorporation.
c. An indicator variable set to one if such provisions were included as a part of the plan of reincorporation, zero otherwise.
d. An indicator variable set to one for those firms that either faced takeover threats, were the subject of takeover rumors, or had significant blockholders that had publicly expressed a desire to influence firm management.

note: All independent variables that represent percentages have been multiplied by 100.

concentration enter equation (i) as significant, suggesting that the market reaction to the passage of these plans is not materially influenced by ownership characteristics. Both measures of firm performance enter the equation as significant, and interestingly, have differing signs. This prompted further investigation. As it turns out, the capital market performance measure (excess return (yr -1) enters the equation as significantly negative because a substantial portion of the firms citing antitakeover motives experienced large excess returns in the year immediately prior to their reincorporation, while the overall reaction to these plans is negative. The significantly positive coefficient on the operating performance variable (OIBD/TA) suggests that *ceteris paribus*, the market responds more favorably to these proposals when firms are performing well. The significantly positive coefficient on the R&D construct is consistent with the predictions of Stein (1988) and suggests that the market responds more favorably when antitakeover measures are adopted by firms with proportionately higher levels of R&D spending. One possible explanation, and that advanced by Stein, is that takeover impediments for firms of this nature allow managers to place the proper emphasis on longer-term R&D intensive projects, with reduced concerned about becoming a takeover target in times when informational asymmetries between the managers and shareholders of these firms lead to depressed stock prices. With the exception of the blank check preferred stock dummy variable, the low t-statistics on the coefficients representing the control provision dummy variables suggest that the nature of the antitakeover barriers adopted does provide a great deal of additional explanatory power beyond the mention of antitakeover motives. The preferred stock dummy, although insignificant in model (i), is negative in both models and is significant in the second model. The negative coefficient on this variable may be indicative of managerial intentions to use these securities in the future to establish a poison pill defense. As was shown in chapter 7 (Table 7) a substantial portion of the sampled firms adopt poison pill defenses in the two years subsequent to their reincorporation. Finally, the significantly negative coefficient on the 'in play' indicator variable suggests that *ceteris paribus*, firms facing external capital market threats experience significantly lower returns by approximately 2% at the passage of reincorporation proposals for antitakeover reasons.

As noted earlier, model (ii) captures a proportionally smaller amount of the variance in the abnormal returns because the dependent variable contains additional noise due to its measurement over a longer window. The results in model (ii) do however, confirm some of the findings in model (i), and also differ in some respects. Similar results are found for the excess return measure and the R&D intensity construct. Explanations for the coefficients on these variables were provided earlier. Interestingly the negative coefficient on the blank check dummy is much more significant in model (ii) than in model (I). In both cases, as was noted earlier, the negative coefficient is likely indicative of market awareness of managerial intentions to adopt further takeover impediments such as poison pills. Finally, the coefficients on both the inside ownership variable and the non-management blockholder variable enter model (ii) as positive and significant. This is in contrast to the findings in the earlier model, however the small coefficients suggest that the economic importance of ownership structure on cross-sectional abnormal returns is nonetheless small.

9.4.2 *Director liability reduction motives, firm attributes, and shareholder wealth*

In those cases where reincorporations are conducted in order to reduce director and officer liability exposure, security price reactions are likely to be influenced by several firm-specific factors as well. These factors may include: firm size, ownership structure, firm performance, R&D intensity, board of director composition (inside vs. outside), and whether or not the firm is constrained in its ability to attract and retain the desired level of outside directors.

Table 16 presents the results of the cross-sectional analysis of abnormal returns for the set of firms reincorporating for director liability reduction reasons. Since the results for both models (i) and (ii) are substantially similar, I will discuss significant findings for both of these models simultaneously. As is evident in both of the estimated models, firm size and ownership characteristics do not materially influence the security price reactions for this set of firms. The sign on the coefficient on the antitakeover dummy variable (significant in model (ii)) confirms the negative effect of additional antitakeover motives on the security price reactions for these firms. The positive coefficients on the operating performance measure (OIBD/TA), although only significant in model (i), suggest that the market responds more favorably to the reincorporations of the set of these firms that are performing well in operations.

As expected, the positive and significant coefficient on the R&D intensity construct in both models suggests that firms with a high level of R&D intensity, thus having a higher propensity for informational asymmetries and earnings volatilities, benefit

Table 16

Cross-sectional regressions of abnormal returns for reincorporations conducted with director liability reduction motives

The Table presents OLS regressions of the abnormal returns for those firms which reincorporated for director liability reduction reasons. The dependent variable in model (i) is the abnormal returns at the passage of these reincorporation plans. In model (ii), the dependent variable is the sum of the 4-day cumulative abnormal returns (CARs) for the interval (0,3) surrounding the earlier of the press announcement or the proxy mailing date and the abnormal return at the passage of the reincorporation plan. Market model parameters are estimated over the period -250 to -51 prior to the event. (t-statistics are presented below parameter estimates in parentheses) *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

	Dependent variable = Abnormal return at the passage of the plan of reincorporation	Dependent variable = CARs (0,3) at the proxy mailing date + abnormal return at passage
Variable	**model (i)**	**model (ii)**
Intercept	0.03043 (1.565)	-0.01594 (-0.509)
Size (log of assets)	-0.00386 (-1.289)	0.00641 (1.331)
Antitakeover dummy	-0.00385 (-0.617)	-0.02232 ** (-2.222)
Inside ownership %	-0.00022 (-1.018)	0.00035 (1.003)
Non-management blockholder %	-0.00011 (-0.384)	0.00051 (1.109)
Institutional ownership %	-0.00003 (-0.112)	-0.00053 (-1.454)
Market-to-book ratio	-0.00526 (-1.513)	0.00284 (0.507)
Excess return (yr -1)[a]	-0.00010 (-1.548)	-0.00018 (-1.601)
OIBD/TA[b]	0.00073 *** (2.598)	0.00015 (0.337)
R&D expenditures / total assets	0.00135 ** (2.007)	0.00199 * (1.851)
Technology dummy	-0.01797 ** (-2.401)	-0.00648 (-0.538)
Inside director %[c]	-0.00002 (-0.127)	-0.02579 (-0.842)
Directors resigned[d]	0.01198 (0.603)	0.04701 (1.471)
Increased outside representation[e]	0.01553 ** (2.317)	0.02079 * (1.929)
N	162	162
R^2	.1351	.1161
Adjusted R^2	.0597	.0390

a. Size decile adjusted returns for the 12 months prior to the reincorporation. (further information is provided in section 8.2.1)

b. For the fiscal year of the reincorporation.

c. The proportion of inside directors at the time of reincorporation.

d. An indicator variable set to 1 for those firms that mentioned outside directors had recently resigned due to concerns of personal liability.

e. An indicator variable set to 1 for those firms that increased the number of outside directors over the two year period subsequent to the reincorporation.

note: All independent variables that represent percentages have been multiplied by 100.

to a greater degree than firms with lower levels of R&D spending. As discussed earlier, firms of this nature are more likely to be involved in shareholder litigation due to the nature of their operations and the volatility in their security prices. Director liability reduction provisions are beneficial to these firms since they lower the threat posed by shareholder lawsuits and thus increase the ability of these firms to attract and retain outside directors with expertise in corporate affairs. Interestingly, the coefficient on the technology dummy variable is negative in both models, and the magnitude is significant in model (i). This was first thought to be a result of multicolinearity with the R&D construct, but further tests proved otherwise. In additional estimations (not presented in the Table) that excluded the R&D construct, the technology variable still showed up as negative, although the significance level fell to approximately 10% (t = 1.661). Therefore the interpretation of the coefficient on the technology dummy is that on average, the fact that the firm conducts operations in technology intensive industries does not lead to greater positive stock market reactions as was initially expected. Instead, it appears that the market reacts more positively to the director liability reduction measures for only the set of these firms that invest heavily in R&D spending.

The last three variables in the Table are designed to measure the extent to which these firms were constrained in their ability to achieve the desired level of outside board representation. As noted in chapter 6, managers frequently mentioned in their reincorporation proposals that the primary benefit of the director liability reduction measures would be that they would enable the firm to attract and maintain quality directors. 7 of the sample firms experienced the resignation of outside directors in the periods leading up to the reincorporation. However, neither the dummy variable representing these firms (although positive) nor the variable representing inside board concentration enter the equations as significant. However, the coefficient on the dummy variable set to one for those firms that subsequently (in the next two years) increased the number of outside directorships is positive and significant in both models. This suggests that the market was able to identify, and responded more favorably, to those firms that credibly committed to increase outside representation. Alternatively phrased, the capital markets responded less favorably for those firms that passed reincorporation plans for these reasons, but were not constrained in their ability to attract outside directors.

9.5 Changes in board of director composition subsequent to reincorporation

The results of the security price analysis presented in Table 8 suggest that on average, capital markets respond in a significantly positive manner to reincorporations conducted in order to reduce director and officer liability. The preceding cross-sectional regressions on the abnormal returns for this set of firms identified that the market responds more favorably to those firms that credibly conveyed their intention to increase the number of outside directors in the 2 year period subsequent to their reincorporation. This finding is consistent with the argument that outside directors serve to align the interests of shareholder and managers through their monitoring of managerial actions.[49]

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[49]Recent empirical research documents that outside directors align managerial action and shareholder incentives across several corporate dimensions. These dimensions include: poison pill plans (Brickley, Coles, and Terry (1994)), tender offers (Byrd and Hickman (1992)), and managerial discipline (Weisbach (1988)). Supporting evidence is

However, the empirical tests conducted thus far to not necessarily imply that on average, firms that reincorporated for director liability reduction reasons were constrained in their ability to attract outside directors, nor do they imply that overall, these firms were committed to increasing outside board representation. In order to provide the answers to these questions, I documented board of director composition for the entire sample of firms both at the time of the reincorporation, and for the subsequent two years. The purpose of this exercise was to determine whether or not those firms that cited director liability reduction motives were more committed to increasing outside board representation than the set of firms that did not reincorporate for director liability reduction reasons.

The information used to determine board composition was taken from proxy statements. Directors were classified as *insiders* if they had any affiliation (past or present) with the firm. Relatives of firm management were also deemed to be *insiders*. Directors were classified as *outsiders* if they had no affiliation (past or present) with the incumbent management team.

Table 17 provides the board composition information and the results of the tests conducted to detect an increase in outside representation. Figures are presented for all firms, those firms that mentioned director liability reduction motives for their reincorporation plans, and for the collection of firms that did not cite director liability reduction as a reason for reincorporating. Panel A presents the results for all firms surviving for at least one year subsequent to their reincorporation. Panel B presents the

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documented by Rosenstein and Wyatt (1990) who find that on average, the appointment of an outside director to the board is accompanied by significantly positive excess returns.

Table 17
Changes in board composition

The Table presents board composition and the increase in outside board representation over both one and two year intervals subsequent to the plan of reincorporation. The figures are presented separately for the entire sample of firms, firms that cited director liability reduction motives, and for the set of firms not that did not mention director liability reduction motives in their reincorporation proposals. Board composition was taken from proxy statements. Directors were classified as *insiders* if they had any affiliation with incumbent management. Relatives of incumbent managers were also classified as *insiders*. Directors were classified as *outsiders* if they had no clear affiliation with management. P-values in parentheses are for paired-comparison t-tests, while p-values in brackets are for Wilcoxon signed ranks tests. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

Panel A	*Board composition and tests of increased outside representation over 1 year – Paired comparisons*

Category	N	Board size, yr 0	# outside, yr 0	% outside, yr 0[a]	% outside, yr 1	difference	avg. % increase[b]	p-value
All firms	340	7.65	4.26	54.26%	55.42%	1.16	5.39%	(.0164)** [.0162]**
Firms that reincorporated for director liability reasons	192	7.05	3.89	53.64%	55.11%	1.47	7.26%[c]	(.0283)** [.0526]*
Firms that reincorporation for other (non-liability) reasons	148	8.43	4.74	55.06%	55.83%	0.77	2.98%[c]	(.2724) [.1634]

Panel B	*Board composition and tests of increased outside representation over 2 years – Paired comparisons*

Category	N	Board size, yr 2	# outside, yr 2	% outside, yr 0	% outside, yr 2[a]	difference	avg. % increase[b]	p-value
All firms	324	7.80	4.43	53.88%	55.82%	1.94	7.63%	(.0059)*** [.0085]***
Firms that reincorporated for director liability reasons	186	7.19	4.12	53.55%	56.16%	2.61	10.17%[c]	(.0033)*** [.0082]***
Firms that reincorporated for other (non-liability) reasons	138	8.55	4.84	54.33%	55.35%	1.02	4.22%[c]	(.3636) [.3494]

a. The % outside ratios cannot be computed directly out of the board size figures in the Table since the % outside ratios represent the mean of individual firm ratios whereas the board size figures are simply mean figures.
b. The avg. % increase is defined as (% outsiders yr(i) / % outsiders yr(0)) -1.
c. The difference in means test for these two groups had a p-value of .14 for the year 1 comparison and .15 for the two year comparison. This indicates that while the increase in outside board representation for those firms that reincorporated for director liability reasons statistically differed from zero and the corresponding increase for the non-liability firms did not, the absolute difference in the increased outside board representation between these two groups is not quite significant at conventional levels.

results for all firms that survived for at least two years. As is evident from Panel A, the overall board size for those firms that did not cite director liability concerns is larger by an average of 1.38 members. This set of firms also had a larger proportion of outside directors serving on their boards. This finding is consistent with the conjecture that some of the firms that reincorporated for director liability reasons may have been constrained in their ability to attract directors. However, it is also possible that the differences in overall board size are an artifact of firm size.

The more interesting question, also addressed in the Table is whether or not those firms that cited director liability motives, and thus stressed the importance of having outside directors, were committed to increasing outside representation in the periods following the adoption of director liability provisions. In order to test this proposition, I compare the increase in outside representation for this set of firms with that of those firms that did not reincorporate for director liability purposes. As shown in Panel A, the average increase in the level of outside representation across the overall sample of reincorporating firms is 5.39%, and is significantly different from zero (5% level). However, further investigation reveals that the majority of this increase is attributable to those firms that mentioned director liability reduction motives. The average increase in outside representation for those firms that did not mention director liability reduction measures is only 2.98% and does not significantly differ from zero, whereas the average increase for the firms mentioning director liability reasons is 7.26% (5% level of significance).

Panel B presents similar results extending over the two year period subsequent to the reincorporations. Once again, the overall sample exhibits a significant increase in outside representation over the period in question. However, the significant increase for the entire sample is driven by those firms that adopted director liability provisions. On average, these firms increased the proportion of outside directors by slightly over 10% over the two year period. The p-values for the t-test and for the Wilcoxon signed rank test indicate significance beyond the 1% level. For those firms that did not adopt director liability reduction provisions, the increase in outside representation over the two year period is only 4.22% and does not significantly differ from zero (p-value = .3656).

The evidence presented in Table 17 suggests that on average, firms that reincorporated in order to adopt director liability provisions significantly increased their levels of outside board representation in the periods following their reincorporation. In contrast, firms that did not reincorporate for these reasons did not substantially increase their outside representation. This finding suggests that, among other things, the sharp increase in shareholder lawsuits during the mid-1980s, and the corresponding crisis in the market for D&O insurance, may have prevented many firms from obtaining their desired level of outside representation. By allowing charter amendments to limit director and officer liability, proactive jurisdictions such as Delaware significantly reduced the magnitude of this problem, and as a result, attracted a significant number of new corporate charters during the crisis in the market for D&O liability insurance. Furthermore, the results of the security price analysis, and in particular the cross-sectional analysis of abnormal returns, suggest that capital markets were able to identify those firms that were constrained in their ability to attract outside board members for liability reasons, and as a result, responded positively when these firms took advantage of corporate laws to counter these difficulties.

9.6 Changes in director and officer ownership subsequent to reincorporation

Hypothesis 4 of chapter 4 predicts that the ownership concentration of firm insiders will decline following the reincorporations. This hypothesis is based on the corporate law theories of Baysinger and Butler (1985), who suggest that firms will naturally migrate to corporate jurisdictions with liberal corporate laws when firm ownership structure becomes more dispersed. In order to test this hypothesis, I examined how the ownership concentration of officers and directors changed in the 3 year period subsequent to the sampled reincorporations.

Table 18 presents the ownership concentration figures. The results of the paired comparisons tests show that overall, insider ownership declined by statistically significant levels over all intervals. After three years, the average inside ownership concentration had declined by over two percentage points (1% level of significance). This finding is broadly consistent with the hypothesis that one of the factors that motivates managers to reincorporate is firm ownership concentration. As was shown in this analysis, a large portion of firms in which insiders had effective control (i.e., ownership levels exceeding 30%), adopted takeover deterrents along with their reincorporation. Collectively, the relatively high, but declining levels of ownership concentration and the high frequency of antitakeover measures are consistent with the conjecture that the managers of many firms

Table 18
Director and officer ownership

Panel A presents inside ownership levels for all firms at the time of the proposal. Surviving firms were followed for a period of three years. Panel B documents a statistically significant decrease in the level of inside ownership over all intervals (one, two and three years). Due to the nature of the data, statistical tests are based on paired-comparisons. Inside ownership figures were taken directly from proxy statements under the caption *ownership of all officers and directors*. If the appropriate proxy statement could not be located, inside ownership figures were taken from the *Disclosure Database*. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels.

Panel A	***Director and Officer ownership levels by year***

Relative year	N	Mean	Median
reincorporation	364	26.46%	23.30%
year 1	343	25.21%	21.80%
year 2	329	24.45%	21.40%
year 3	321	23.73%	20.20%

Panel B	***Reduction of inside ownership levels over a 3-year period – Paired Comparisons***

Through 1 year		**Through 2 years**		**Through 3 years**	
N	343	N	329	N	321
time 0	26.14%	time 0	25.85%	time 0	25.89%
after 1 year	25.21%	after 2 years	24.45%	after 3 years	23.73%
net change	-0.93%	net change	-1.40%	net change	-2.16%
t-statistic	-1.966**	t-statistic	-2.483**	t-statistic	-2.998***
p-value	.0501	p-value	.0135	p-value	.0029

use a reincorporation as a vehicle to subject the firm to liberal corporate laws, under which they have an increased likelihood of maintaining effective control of the firm, even after their relative voting power has diminished. It is perhaps for this reason that such a substantial portion of the initial sample, 448 of 1004 firms (45%), reincorporated either preceding or surrounding an initial public offering and listing on one of the major stock exchanges.

9.7 Chapter summary

This chapter has presented the results of a battery of empirical tests on the sample of reincorporating firms. Several interesting findings emerge from these tests. First, as was predicted, security price reactions to the reincorporations that have occurred in the past decade are dependent upon the motives cited by managers. Although the security price reactions to the set of firms that cited antitakeover motives are significantly negative, the evidence suggests that these firms are not, on average, erecting takeover barriers because they are performing poorly. Rather, these firms are on average, characterized by higher than expected levels of both operating and capital market performance, high market-to-book ratios, lower dividend payout rates, and smaller average shareholdings. These attributes are consistent with the conjecture that the managers of these firms reincorporate to a more liberal state when the former chartering state does not afford them the desired level of protection from unsolicited takeover attempts. The relatively high, but declining inside ownership concentration, when viewed collectively with the high market to book ratios and lower dividend payout rates, suggests that the managers of these firms choose to reincorporate and erect impediments to future takeover threats *prior to* when future external financing activities might lower their effective control and increase the firm's susceptibility to takeover attempts.

When firms reincorporate in order the adopt provisions that limit director liability, capital markets on average, respond in a significantly positive manner. Logistic regressions indicate that the firms that reincorporated for this reason were primarily high technology firms, with high levels of R&D intensity. These firms are more likely to be adversely impacted by the threat of shareholder lawsuits due to volatile stock prices arising out of the high levels of informational asymmetry between firm managers and shareholders. An analysis of the board composition for this set of firms suggests that the adoption of director liability reduction provisions, made possible by reincorporation to a state (primarily Delaware) with this possibility in its corporate laws, may have relaxed some of the concerns of expert outside directors (such as personal wealth exposure), and as a result, enabled these firms to significantly increase outside board representation in the periods following their reincorporation. The fact that the remainder of sampled firms did not experience a similar increase in outside representation in the periods following their reincorporations provides further evidence in this regard.

When reincorporations are conducted for reasons other than antitakeover and director liability purposes, security price reactions are found to be insignificant. However, logistic regressions reveal that the migrations of these firms are to some extent, prompted by reasons (such as firm attributes) that are consistent with the predictions of contractual efficiency theories.

CHAPTER 10

SUMMARY AND CONCLUSIONS

This study examines the reincorporation decision for a large sample of public corporations over the period 1980 to 1992. In theory, such decisions can be either beneficial or detrimental to shareholder wealth. During the last decade, changes in the corporate environment such as heightened takeover activity and the crisis in the market for D&O liability insurance, and corresponding changes in state corporation laws have magnified the relationships between the decision to reincorporate, shareholder wealth, and corporate governance mechanisms.

While the overwhelming majority of reincorporation proposals during this time period are successful, the evidence suggests that the market reaction to the decision is dependent upon the motive(s) for reincorporation. The empirical tests in this study reveal that capital markets respond positively to reincorporations that provide for improved governance and negatively to the set of firms that use a reincorporation as a vehicle to relax capital market governance mechanisms. In addition, logistic and cross-sectional regressions reveal significant relationships between managerial motives, firm attributes, and shareholder wealth. Collectively, this study provides evidence that changes in the corporate environment and state corporation laws during the 1980's have exerted significant influence on the chartering decisions of modern corporations.

The most common reason for the reincorporations in the sampled period is to reduce the outside threats faced by corporate decisionmakers. The typical reincorporation during this period is carried out either (i) to reduce the risk arising from an active market for corporate control, and/or (ii) to reduce the risk and costs arising from lawsuits alleging mismanagement. On average, during the last decade, capital markets have responded negatively to those firms that used a reincorporation as a vehicle to provide protection from the market for corporate control, and positively to those firms that used a reincorporation as a vehicle to take advantage of state corporation laws that provide liability protection for corporate decisionmakers. However, in those cases where managers reincorporate in order to adopt takeover restrictions, the evidence suggests that these firms were on average, performing well. These firms exhibit characteristics consistent with the need for future external financing, and the patterns of ownership concentration over time are consistent with the conjecture that on average, the managers of these firms reincorporate to more liberal jurisdictions and adopt takeover restrictions prior to when the firm may become vulnerable to unsolicited takeover attempts due to lower levels of ownership concentration. In those cases where managers reincorporated in order to adopt director liability reduction provisions, the collection of evidence suggests that these provisions were beneficial to shareholder wealth. On average, those firms that reincorporated for this reason significantly increased their outside board representation in the periods subsequent to their reincorporations. This finding suggests that the adoption of these provisions, and thus, the reincorporation that made the adoption possible, assisted these firms in relaxing the constraints imposed by the crisis in the market for D&O liability insurance and improved their ability to attract and retain outside directors. Thus, reincorporations for this reason led to improved corporate governance.

This study also presents evidence that the majority of reincorporations contain provisions designed to increase managerial control over the firm. Over 3/5 (62%) of the sampled firms adopt at least one charter provision that either restricts shareholder voting rights or has antitakeover implications. The bulk of these charter amendments are adopted at the time of the reincorporation, however managers frequently use financial securities (such as blank-check preferred stock) authorized in the plan of reincorporation to adopt poison pill plans in the years subsequent to the move.

Further, managerial ownership declines by statistically significant levels after a reincorporation to a more liberal state. This is broadly consistent with hypotheses suggesting that firms will migrate to jurisdictions with flexible corporate laws when ownership becomes dispersed enough to make liberal corporate codes desirable.

Finally, the overall evidence presented in this analysis illustrates the important role that reincorporations, or threats of reincorporations, have upon state corporation laws. This is particularly evident in the sampled period with regard to director liability issues and is also apparent in the patterns of state antitakeover legislation across time. In the case of director liability issues, the evidence presented in this study shows that reincorporations play an influential role in forcing states to adopt provisions that are desirable to corporate managers. The state of Delaware modified its corporate laws in 1986 to allow for charter amendments to limit director liability, and in doing so, provided managers with a means to recontract, and eliminate much of their decisionmaking risk. This put pressure on other chartering jurisdictions to pursue similar modifications in their corporation laws. States that were slow in doing so, lost a large portion of firms due to reincorporation and were eventually forced to modify their laws in this area to stop the migrations. Thus, it is apparent that the competition among the states in the market for corporate charters plays a significant role in influencing both the direction of, and the parity among, state corporation laws. The question that remains is, in which direction are they going?

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APPENDICES

APPENDIX A

Survey of reincorporating firms

The majority of the information collected regarding the reincorporation of the sampled firms was obtained from proxy statements, other SEC filings, and from various sources in the business press. Although these sources provided the necessary information in sufficient detail, a questionnaire was also sent to the surviving firms in order to provide a supplement to the primary information sources and to gather further information not frequently reported in either SEC filings or the business press.

The questionnaire was mailed out to the 284 firms (78% of the total sample) for which a current address (as of the end of 1993) could be obtained. A total of 60 firms (21%) responded to the request. Of those 60 firms that responded, 8 indicated that they could not participate in the survey for various reasons, 40 (14% of the surveyed firms) provided the proxy statement that contained the proposal, and 31 (11%) returned the questionnaire with responses to those questions for which the relevant information was available in company' archives. Given the relatively low overall response rate and the wide degree of variation among the responses, the information provided by the surveyed firms was not well suited for empirical tests. Instead, the responses to the questionnaire served to complement the information obtained from additional sources, in some cases shedding additional light on those issues that may play an influential role in the decision to reincorporate.

The remainder of Appendix A contains both a copy of the request for information and a copy of the accompanying questionnaire.

PURDUE UNIVERSITY

SCHOOL OF MANAGEMENT

KRANNERT GRADUATE SCHOOL OF MANAGEMENT

December 19, 1994

CHIEF EXECUTIVE OFFICER
«CONM____________»
«STREET»
«SUITE»
«CITY», «STATE» «ZIP»

Dear Sir or Madam:

I am a Ph.D. student in Finance at Purdue University. I am currently working on my doctoral dissertation about state corporation laws and the decision to reincorporate. According to my sources, «conm2» reincorporated in «yr». I would be greatly appreciative if you can provide me with some information about the Company's decision to reincorporate and its impact on the firm. The specific information that I am interested in can be found on the enclosed form. My research would benefit substantially if you could provide this information. Moreover, I would highly value copies of the following:

1. All press releases regarding the decision to reincorporate, and
2. the proxy statement proposing the move.

Due to information constraints, my sample consists of a relatively small number of firms, and, hence, it is important to my research that I obtain this information for as many firms as possible. I would therefore again like to state how much I would appreciate your help in this regard. Furthermore, if you so desire, I am willing to sign an agreement to ensure that the information remains confidential.

Thank you for your consideration.

Sincerely,

Randall A. Heron

<u>Enclosure</u>

1310 KRANNERT BUILDING • WEST LAFAYETTE, IN 47907-1310 • FAX (317) 494-9658 •
E-MAIL : HERONRA@VM.CC.PURDUE.EDU

Company Name: «conm2»	Year of Reincorporation: «yr»

Please provide as much of the following information as possible.

1. What was the motive behind the reincorporation?

2. Was the move in response to a specific change in the corporate laws of the firm's former and/or current corporate jurisdiction? If so, what specific changes?

3. What was the approximate out-of-pocket cost of the reincorporation?

4. Annual chartering fee prior to the reincorporation:
5. Annual chartering fee for the year after the reincorporation:
6. Percentage of voting shares that approved the proposal:
7. On what date did the Board of Directors approve the decision?
8. On what date was the decision to reincorporate first announced to the public?
9. On what date was the corporate entity formed in the new state of incorporation?
10. Did the change in the corporate charter allow the firm to obtain financing and/or implement changes in the firm's capital structure that were not available to the firm prior to the reincorporation? If so, please explain.

11. Were there any outside attempts to gain control of the firm and/or exert influence on management in the year prior to the reincorporation? If so, please explain.

12. Were any of the following antitakeover measures in place prior to the reincorporation?

Classified Board	☐	Straight voting (not cumulative)	☐
Fair Price Provision	☐	Blank Check Preferred Stock	☐
Business Combination Restrictions	☐	Poison Pill Plan	☐
Supermajority Agreement	☐	None of the above	☐

13. Did the firm adopt any of the following measures as a part of the reincorporation plan or within 1 year of the reincorporation?

Classified Board	☐	Straight voting (not cumulative)	☐
Fair Price Provision	☐	Blank Check Preferred Stock	☐
Business Combination Restrictions	☐	Poison Pill Plan	☐
Supermajority Agreement	☐	None of the above	☐

14. One of the main reasons offered for reincorporation in the last decade has been to take advantage of corporate laws that allow for the reduction of director liability. Was this a factor in «conm2»'s decision? Yes ☐ No ☐
If the answer to question 14 was yes, please answer the following questions.
15. Prior to the reincorporation, did any of the firm's directors resign due to a lack of sufficient liability protection? Yes ☐ No ☐
16. Was the inability to obtain sufficient Director and Officer liability insurance a factor in the reincorporation decision? Yes ☐ No ☐
17. Was the opportunity to get Director and Officer liability insurance at more reasonable rates a factor in the reincorporation decision? Yes ☐ No ☐
18. What were the approximate savings (if any) in annual D&O insurance premiums immediately after the reincorporation?
19. What was the approximate change in D&O liability insurance coverage as a result of the decision? No change ☐ Total Coverage increased by ____________________ Total Coverage decreased by____________________

Please return to:

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APPENDIX B

Within-sample multivariate logistic regressions

The within-sample logistic regressions shown here complement the logistic regressions presented in chapter 9 by further identifying the relationships between firm attributes and reincorporation motives. The independent variables capture firm attributes such as size, ownership, operating characteristics, performance, and incorporation state.

Table B1 presents the results of the estimated logistic regressions for those firms that cited either antitakeover motives (models (i) and (ii)) or director liability reduction motives (models (iii) and (iv)). Several notable results are evident in the Table. First, those firms that reincorporated for antitakeover reasons tended to perform better in capital markets than their reincorporating counterparts. This finding is similar to that found in the capital market performance analysis in Table 10 of chapter 9. The evidence also suggests that firms seeking takeover protection are more likely to conduct operations in capital-intensive, as opposed to technology-intensive industries. The significant coefficient on the California dummy variable indicates a high correlation between antitakeover motives and previous incorporation in the state of California, a shareholder rights state.

The results of models (iii) and (iv) suggest that firms that reincorporated in search of director and officer liability protection tended to be smaller, technology-intensive firms that were originally chartered in California As suggested earlier, the vulnerability of small, technology oriented firms to the threat of shareholder suits, coupled with the strictness of California's corporate laws, motivated large numbers of such firms to relocate to chartering jurisdictions that offered increased protection for corporate decisionmakers.

Table B1
Within-sample multivariate logistic regressions
Antitakeover and director liability reduction motives

The Table presents within-sample multivariate logistic regressions of firm characteristics on antitakeover and director liability reduction motives. In model (i) the dependent variable is one if firm management mentioned solely antitakeover motives and zero for all firms not mentioning antitakeover motives. Model (ii) presents the estimates where the dependent variable is one if antitakeover motives were cited and zero otherwise. Model (iii) presents the estimates of a logistic regression where the dependent variable is one if firm management cited solely director liability reduction motives and zero for all firms not mentioning director liability motives. Model (iv) then presents the corresponding estimates where the dependent variable is one for all firms that cited director liability reduction motives and zero otherwise. (p-values) *,**,*** denote statistical significance at the 10%, 5%, and 1% levels.

	Antitakeover motives		Director liability motives	
Variable	**model (i)**	**model (ii)**	**model (iii)**	**model (iv)**
Intercept	-2.6356 **	-0.7162	0.2106	0.7764
	(.0434)	(.3485)	(.8523)	(.2872)
Size (log of assets)	0.2585	-0.0425	-0.1805	-0.3112 ***
	(.1284)	(.6835)	(.3059)	(.0029)
Debt ratio	0.0028	0.0061	-0.0134	0.0053
	(.8314)	(.3851)	(.2597)	(.4746)
Insider ownership[a]	0.0078	0.0004	-0.0016	-0.0005
	(.6187)	(.9643)	(.9060)	(.9518)
Sales growth[b]	-0.0243 **	-0.0031	0.0009	0.0029
	(.0492)	(.4390)	(.2037)	(.4502)
Dividend payout[c]	0.1568	0.4645 ***	-0.3796	-0.0349
	(.4652)	(.0035)	(.2005)	(.5849)
Capital expenditures / TA	0.0336	0.0434 *	-0.1138 **	-0.0383
	(.4128)	(.0811)	(.0106)	(.1267)
R&D / TA	-0.0310	0.0027	0.0112	0.0295
	(.5187)	(.8966)	(.7447)	(.2596)
Market-to-book	0.0242	-0.0678	0.0804	-0.0060
	(.9204)	(.5523)	(.6681)	(.9591)
2 year adjusted return[d]	0.0053 *	0.0036 **	0.0009	0.0011
	(.0937)	(.0431)	(.7523)	(.3286)
OIBD / TA	0.0079	-0.0035	-0.0347 *	0.0019
	(.7804)	(.7714)	(.0775)	(.8806)
Pressured[e]	0.0810	0.1505		
	(.9246)	(.7783)		
>5% outside blockholder[f]	0.2797	0.2917		
	(.5387)	(.2784)		
% inside board	-0.0163	0.0013	0.0034	0.0046
	(.2376)	(.8627)	(.7871)	(.5634)
Technology[g]	-1.1202 *	-0.1715	1.1109 **	0.7870 **
	(.0586)	(.5718)	(.0198)	(.0163)
California[h]	1.8364 ***	1.0252 ***	1.5136 ***	1.2520 ***
	(.0003)	(.0005)	(.0008)	(.0001)
Model χ^2 statistic	39.623 ***	34.733 ***	65.223 ***	64.943 ***
	(.0005)	(.0027)	(.0001)	(.0001)
Pseudo-R^2[i]	.21	.09	.28	.16
N	167	299	186	299

a. Represents director and officer ownership as taken from the proxy statement proposing the change.
b. Represents the average yearly growth in sales for the years -2 to +2.
c. Represents the percentage of sales distributed as dividends.
d. The sum of size-decile adjusted returns for the year prior to and subsequent to reincorporation.
e. Assumes a value of one if the firm faced capital market pressures in the year prior to reincorporation and zero otherwise.
f. A binary variable set to one if the firm had at least one >5% non-management blockholder at the time of reincorporation.
g. Assumes a value of one if the firm's SIC code is between 3500 and 3700 or 3800 and 3900
h. Assumes a value of one if the state of exodus was California, zero otherwise.
i. Pseudo-R^2 is similar to that of R^2 in multiple regression. It is defined as 1 - (log likelihood at conversion / log likelihood at zero).
note: All independent variables that represent percentages have been multiplied by 100.

Table B2 presents the results of logistic regressions conducted for the remaining classifications of reincorporation motives. The results shown for model (i) are consistent with the earlier findings. They indicate a high correlation between tax or fee reduction motives and reincorporation **out of** Delaware, a state that imposes a substantially higher chartering fee than most other chartering jurisdictions. Further, the evidence in the model indicates that firms citing tax or fee reduction motives tend to have performed poorer in the periods surrounding their reincorporations than did the remainder of the reincorporating firms. Thus, as suggested earlier, poor performance may play an influential role in motivating managers to reincorporate and reduce taxes or fees.

Model (ii) contains two interesting findings. First, the negative coefficient on the dividend payout variable indicates a negative correlation between dividend payout rates and flexibility motives. This finding is not unexpected since a large portion of the firms that reincorporated for these reasons indicated that the reincorporation would facilitate future financing activities. Second, the significantly negative coefficient on the California dummy variable indicates that these firms are more likely to have reincorporated out of chartering jurisdictions other than California.

Finally, model (iii) presents the estimated logistic regression for those firms that cited domicile reconciliation motives. The most significant variables in the equation are the state dummy variables, which indicate that these firms were less likely to have been incorporated in California and that they were more likely to have left the state of Delaware, perhaps due to Delaware's relatively excessive chartering fees.

Table B2
Within-sample multivariate logistic regressions
Tax/fee reduction, flexibility, and domicile reconciliation motives

The Table presents within-sample multivariate logistic regressions of firm characteristics on tax/fee reduction, flexibility, and domicile reconciliation motives. Model (i) presents the estimates of a logistic regression where the dependent variable is one if the firm mentioned tax or fee reduction as the sole reason for reincorporation and zero for firms not mentioning tax/fee reduction motives. Model (ii) presents the results where the dependent variable is one if the firm mentioned flexibility as the sole reason for reincorporation and zero otherwise. Model (iii) presents the results for firms mentioning state of domicile reasons for reincorporation and zero for firms not mentioning domicile reconciliation motives. (p-values) *,**,*** denote statistical significance at the 10%, 5%, and 1% levels.

	Tax/fee	Flexibility	Domicile
Variable	**Model (i)**	**Model (ii)**	**Model (iii)**
Intercept	-4.3509 *	-0.6580	-6.1892 ***
	(.0986)	(.6584)	(.0005)
Size (log of assets)	-0.0683	0.1396	0.1853
	(.8582)	(.5135)	(.4435)
Debt ratio	0.0110	-0.0042	-0.0126
	(.6372)	(.7654)	(.5033)
Insider ownership[a]	0.0081	-0.0149	0.0261
	(.7746)	(.3676)	(.1590)
Sales growth[b]	0.0098	0.0076	-0.0127
	(.4511)	(.3002)	(.4156)
Dividend payout[c]	0.0466	-0.8879 *	0.0018
	(.4935)	(.0660)	(.9838)
Capital expenditures / TA	0.0420	-0.0418	0.0877 **
	(.5275)	(.3577)	(.0351)
R&D / TA	-0.1684	-0.2227	-0.0801
	(.5637)	(.1245)	(.5200)
Market-to-book	-0.5580	-0.6686	0.2425
	(.6530)	(.3147)	(.3149)
2 year adjusted return[d]	-0.0172 *	-0.0012	-0.0010
	(.0675)	(.6462)	(.7849)
OIBD / TA	-0.0294	0.0437	0.0446
	(.4873)	(.2515)	(.2169)
Technology[e]	-0.3554	0.8861	1.2511
	(.8500)	(.2973)	(.1782)
California[f]		-2.9294 ***	-2.1338 *
		(.0066)	(.0678)
Delaware[g]	5.4585 ***		3.4079 ***
	(.0001)		(.0001)
Model χ^2 statistic	53.450 ***	37.216 ***	46.582 ***
	(.0001)	(.0002)	(.0001)
Pseudo-R^2 [h]	.51	.26	.36
N	280	233	300

a. Represents director and officer ownership as taken from the proxy statement proposing the change.
b. Represents the average yearly growth in sales for the years -2 to +2.
c. Represents the percentage of sales distributed as dividends.
d. The sum of size-decile adjusted returns for the year prior to and the year subsequent to reincorporation.
e. Assumes a value of one if the firm's SIC code is between 3500 and 3700 or 3800 and 3900.
f. Assumes a value of one if the firm's state of exodus was California, zero otherwise.
g. Assumes a value of one if the firm's state of exodus was Delaware, zero otherwise.
h. Pseudo-R^2 is similar to that of R^2 in multiple regression. It is defined as 1 - (log likelihood at conversion / log likelihood at zero).
note. All independent variables that represent percentages have been multiplied by 100.

VITA

VITA

Randall Allen Heron was born September 28, 1968, in Macomb, Illinois. He graduated magna cum laude with a B.S. degree in accounting from Western Illinois University in 1990. He received a Master of Business Administration degree with an emphasis in finance from Western Illinois University in 1991.

He received a Ph.D. in Management from Purdue University in December 1995. Financial support was received from Purdue University through serving as a research assistant for two years, a teaching assistant for one year, and through a Krannert Thesis Grant. He is currently at the College of Business Administration at the University of Notre Dame.