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On the Motives for Choosing a Corporate Governance Structure: A Study of Corporate Reaction to the Pennsylvania Takeover Law

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1. Introduction

In early 1990, the state of Pennsylvania adopted a takeover law that imposed new requirements on both hostile acquisition offers and proxy challenges launched against Pennsylvania-incorporated firms. The law (commonly referred to as SB 1310) also contained a limited-duration opt-out provision. Firms not wishing to be covered could exempt themselves from the law's coverage during the first 90 days that it was in effect, through written notification and without a shareholder vote. During the opt-out period, a significant number of Pennsylvania corporations chose to opt out of some or all of SB 1310.

The limited-time, no-vote opt-out provision contained in SB 1310, coupled with the relatively large number of firms choosing to opt out, created a unique control experiment. Under this experiment, managements of many public corporations made virtually contemporaneous decisions about whether to accept or reject new, exogenously imposed protections from takeovers and proxy contests. This self-selecting behavior creates an opportunity to investigate the motives for choosing a corporate governance structure. Differences between firms choosing to be covered by the law and firms choosing to recuse themselves from coverage provide inferential evidence on the validity of

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various theories about the motives for choosing a more or less restrictive corporate governance structure.

In this article, I provide empirical evidence on the characteristics of firms choosing to opt out of SB 1310 and those choosing to remain covered by the law. Data are provided on long-term accounting performance, cost structure, long-term financial performance, market valuation, internal resources, investment and spending patterns, corporate governance structure, and ownership structure. The data are for a sample of 135 firms whose opt-out decisions have been determined through a survey by a Pennsylvania law firm that tracked the opt-out decisions of all Pennsylvania-incorporated companies with market capitalizations greater than $10 million.

The tests reveal a series of systematic differences between firms opting out of SB 1310 and those choosing not to opt out of the law. A first important difference is in pre-existing governance structure. Firms choosing *not* to opt out of SB 1310 were more heavily protected from takeovers prior to their opt-out decision than were firms choosing to opt out of the law. Over 75 percent of firms choosing not to opt out of SB 1310 had poison pill takeover defenses in place at the time of their opt-out decision, while only 25 percent of opting-out firms had poison pill protections in place during the opt-out period. No other systematic differences are evident in major takeover protections, such as unequal voting plans, supermajority provisions, or staggered boards. Firms not opting out of the law, thus, had more frequently sought a form of takeover protection that did not require a shareholder vote, but had not asked shareholders to approve significantly more protections requiring a vote.

Significant differences also obtain in the areas of financial valuation, stock returns, and payout behavior. Firms choosing *not* to opt out of SB 1310 display lower market valuation ratios than their peers, measured in terms of price-to-earnings and price-to-cash-flow ratios. Concurrently, firms not opting out of the law display higher one-year stock returns. Finally, firms opting out of SB 1310 display higher payout ratios than their peers, measured as total interest plus dividends as a fraction of total interest plus cash flow.

A significant difference is also apparent in ownership structure. Firms opting out of SB 1310 display significantly higher insider ownership than firms choosing to remain covered by the law. Median inside ownership among opting-out firms, at 13.8 percent, is high enough to plausibly spur higher managerial incentives, higher valuations, and, hence, less need for takeover protections, compared to the 6.9 percent median insider ownership present at firms not opting out of SB 1310. There are no significant differences in average ownership by institutional holders, outside individual blockholders, or institutional blockholders.

The data show no significant differences in long-term accounting or operating performance, or the relative size of internally available resources, between firms opting out and not opting out of SB 1310. There is statistical and economic equivalence in measures including return on assets, operating margin, cash flow as a percent of assets, sales general and administrative costs as a percent of sales, and cost of goods sold as a percent of sales. Nor are there broad systematic differences in spending and investment behavior. Equivalence is evident in measures including research and development as a percent of sales, capital expenditures as a percent of sales, and capital spending as a percent of assets. Firms seeking SB 1310's protections were thus not "big spenders" or weak and inefficient in terms of past economic performance.

Viewed broadly, this evidence can be seen as consistent with the hypothesis that takeover protections are sought by firms with lower internal incentives and more principal–agent slack, that are making current investment decisions that have created market skepticism about future growth rates. The resulting low valuation creates the threat of takeover and hence the motive to seek protection. The data suggest that takeover pressure and low valuation are not linked to poor historical performance, but rather, to current plans and strategies. In addition, the results show that these firms tend to seek multiple nonvoting protections, while firms not under such pressure tend to reject the opportunity to enact such nonvoting protections.

2. The Pennsylvania Law and Theories of Governance Structure

Pennsylvania Senate Bill 1310, subsequently Act 36 of Pennsylvania Public Law 129, was adopted by the Pennsylvania legislature and signed by the governor in April 1990. It added four new provisions to Pennsylvania law. They are a control share acquisition provision, job protections for employees in the event of a takeover, a relaxation of directors' fiduciary duty to shareholders in considering takeover offers, and a "disgorgement" provision. The latter provision mandates that a shareholder who undertakes a proxy initiative or takeover bid must return to the corporation any profits realized on shares bought within 18 months of the bid and sold within 18 months thereafter.

The Pennsylvania bill contained an opt-out provision that allowed Pennsylvania-incorporated firms to recuse themselves from coverage under SB 1310 for a period of 90 days after the bill was signed into law. To opt out, corporations had to notify the Secretary of the Commonwealth in writing by the end of the opt-out period; no shareholder vote or other costly action was required. A total of 99 corporations are publicly known to have opted out of one or more provisions of Act 36 by the end of the 90-day period. Of these 99 firms, 35 opted out of all provisions; 53 opted out of the disgorgement, labor, and control share provisions; 2 opted out of the disgorgement provisions only; 8 opted out of the control share and labor provisions; and 1 reincorporated to Delaware. Thirty-six companies are known to have chosen to be governed by all provisions of Act 36.

At a broad level, two competing theories exist to explain decisions by corporate managers to adopt or not adopt restrictive governance structures such as those contained in SB 1310. One theory is that the decision is in shareholders' interests and results in a more efficient corporate incentive structure. The alternative hypothesis is that managers choosing restrictive structures do so out of self-interest, in order to escape pressure from the market for corporate control and gain additional latitude.

These two hypotheses have direct implications for the characteristics of firms opting in or out of the Pennsylvania law. If managerial self-interest is driving the opt-out decision, then firms *not* opting out of the law should display pre-opt-out characteristics that are consistent with greater agency slack. This would indicate that, at these firms, managers' interests diverge more from those of shareholders. In the vernacular, companies not opting out of the law should have some economic, incentive, or governance characteristics that would make managers more eager to seek protection. Conversely, companies opting out of the law should display characteristics consistent with less agency slack.

If the alternative shareholders' interests theory is correct, then there should not be systematic differences in corporate performance, incentives, or governance structure that would suggest greater agency slack across firms opting out and not opting out of SB 1310. Instead, there should be either little difference between the companies, or differences that suggest that it is in shareholders' interests for companies not opting out of the law to have chosen to remain covered by its provisions.

A number of specific theories have been advanced about the causes and consequences of agency slack, and hence the characteristics likely to be displayed by opting-out and not-opting-out firms if management self-interest, rather than shareholders' interests, is driving the opt-out decision. One possibility is that firms remaining covered by SB 1310 will show worse pre-opt-out historical performance than firms choosing to opt out. This would be consistent with the hypothesis that firms become the subjects of takeovers and proxy contests after sustained periods of poor performance, and that poorly performing managers seek protection to escape this external pressure. A second possibility is that firms remaining covered by SB 1310 would show lower valuation prior to the opt-out decision. This would be consistent with the hypothesis that takeover pressure occurs at companies that are making mistakes in their current investment and capital allocation decisions, and that protection is sought when poor decisions about the use of the firm's resources lead to low market confidence in expected future performance. A third possibility is that firms remaining covered by the law could show higher levels of internal resources at the time of the opt-out decision. This would be consistent with the hypothesis that agency problems tend to obtain, and takeover pressure occurs, at mature firms with high levels of internal resources, because these excess resources tend to lead to poor investment decisions (Jensen). A fourth potential difference is lower ownership by insiders among firms not opting out of the law. This would be consistent with the hypothesis that there is a lower level of internal incentives guiding managers at these firms. Finally, it is possible that differences in corporate governance structure may exist between opting-out and not-opting-out firms. Firms not opting out may have fewer takeover protections, and hence be seeking greater protection through a law that substitutes for firm-specific protections; or they may have more protections, and thus display a sustained managerial preference for more insulation from the market.

If the decision to remain covered by SB 1310 or to opt out is made in shareholders' interests, the foregoing differences should not be present across firms opting out and not opting out of the law. Instead, several alternative outcomes are possible. One is that there will be no systematic performance or incentive differences between opting-out and not-opting-out firms. This would suggest that governance structure decisions are a function of optimal contracting between management and shareholders, chosen to correct idiosyncratic problems such as risk aversion in management or an opaque information structure that would render the firm an easy takeover candidate (Demsetz and Lehn; Lehn, Netter, and Poulsen). Equivalently, no difference between opting-out and not-opting-out firms could suggest that some managers adopt restrictive governance structures in order to bargain in shareholders' interests in the event of a takeover bid, but not to deter takeovers from occurring. Another pro-shareholder explanation is that firms making a high level of long-term investment seek takeover protections, because the market penalizes such investment because of its short-term outlook, and this in turn leads to takeover bids against firms that are investing for the long term. Under this theory, firms seeking protections should display higher levels of research and development and capital spending, and the additional protections would serve shareholders' interests by allowing this investment to take place without the threat of a disruptive outside takeover bid for the company (Lipton and Rosenblum; Stein).

Existing evidence on firm-specific decisions to adopt takeover defenses has provided inferential support for the managerial interest hypothesis, while contradicting the predictions of the shareholders' interest hypothesis. Decisions during the 1980s to adopt both antitakeover charter amendments and poison pills has been shown to have neutral to negative effects on share prices (Jarrell and Poulsen; Ryngaert; Malatesta and Walkling). Corporate performance prior to poison pill adoptions has been shown to be low on an industry-adjusted basis (Malatesta and Walkling). Firms adopting antitakeover charter amendments tend to lower their spending on research and development after adoption, in direct contradiction to the long-term planning hypothesis (Meulbroek et al.). In addition, corporations with more restrictive corporate governance structures have been shown to exhibit reduced long-term post-adoption performance (Gordon and Pound).

Similarly, existing evidence on state takeover laws, which assesses their effects on the stock prices of firms incorporated or headquartered in the state in question, also inveighs against shareholders' interest explanations for these forms of protection. All second-generation state laws as a group have been shown to result in a slight but statistically significant reduction in share prices (Karpoff and Malatesta, 1989). The Pennsylvania law in particular has been shown to result in a significant negative impact on Pennsylvania-incorporated firms (Szewczyk and Tsetsekos; Karpoff and Malatesta, 1990). In addition, the stock price effects of state laws have been shown to be most significant at firms that already lack other forms of takeover protection, such as poison pills, suggesting that state laws may function as a substitute for firm-specific protective devices (Karpoff and Malatesta, 1989).

3. Sample Data, and Tests

The sample of firms for this article's tests is based upon survey work conducted by the law firm of Klett, Lieber, Rooney, and Schorling in the months surrounding the opt-out period. Klett, Lieber served as counsel to several groups who lobbied in opposition to SB 1310 during the period of legislative consideration. After passage, the law firm tracked the opt-out decisions of Pennsylvania companies at the behest of several clients and some large institutional investors who wished to incorporate this information into their voting decisions.

Klett, Lieber surveyed companies directly, and checked both state and federal filings for opt-out information. They determined the opt-out status for 135 companies. This consists of all publicly traded Pennsylvania corporations with $10 million or more in market capitalization. This set consists of 99 firms that announced a decision to opt out of at least one provision of SB 1310, and 36 firms that did not opt out of any provision of the law.

Of this base sample, the tests in this article utilize subsets for which data are available. Economic performance data are drawn from Compustat. Compustat's coverage is relatively complete save for the smallest firms and some financial institutions. Hence, the economic performance tests utilize a sample of 98 out of 135 total possible firms. Corporate governance data are drawn from the Investor Responsibility Research Center's (IRRC's) annual compilation entitled Corporate Takeover Defenses. This data base covers the 1,500 largest American companies. This more restrictive coverage narrows the sample for the governance tests to 51 firms. Complete data on inside and block ownership were found for a sample of 124 firms using proxies. Institutional ownership data were secured for 89 firms using Standard and Poor's sources.

Three variables—return on assets, operating margin, and asset turnover—measure long-term accounting performance. The size of internal resources is measured by the ratio of cash flow to assets. Spending behavior is measured by the ratios of research and development to sales, capital spending to sales, and capital spending to assets. Cost control—a variant of spending behavior—is measured by the ratio of sales, general, and administrative expenses to sales, and cost of goods sold as a percent of sales, as well as by operating margin. Payout behavior is measured by the ratio of dividends and interest to cash flow plus interest. Each of the foregoing ratios is computed as a five-year average, ending with the fiscal year prior to enactment of SB 1310 (1989). Valuation is measured by the ratio of earnings to market value and cash flow to market value. These measures are the inverse of standard valuation ratios, and are used because they remain sensible in the domain of negligible, zero, and negative earnings. Valuation ratios are computed at the end of the calendar year prior to enactment of SB 1310, or approximately 120 days prior to the beginning of the opt-out period, to control for any valuation effects arising from the anticipated opt-out decision itself. Finally, short-run stock performance is measured over the calendar year prior to adoption of SB 1310 (1989), and the long-run measure examines the prior four years without including the short-run measurement period, to provide a complementary perspective that is not driven by the same endpoint as is the one-year measure.

Each variable is measured on an industry-adjusted basis. The observation for each firm is compared to the range of observations for its industry peers. Industry groups are defined as the universe of firms appearing in Compustat with the same four-digit primary SIC code. Each observation for a sample firm is assigned a percentile score reflecting its rank in the industry universe. Percentiles are used as the unit of measurement since they overcome problems associated with the poor distribution of both the accounting and the stock returns data. Within industry groups, some measures are extremely fat-tailed; others have very thin tails. The percentile approach allows an examination of where firms lie in the distribution while imposing no restrictions on the shape of the distribution. As a check on this approach, the tests were replicated using medians. Results were consistent with those reported for percentiles. As the percentile approach conveys more information about where firms stand in the overall distribution, I report those results in this article.

Governance data, drawn from the 1990 edition of IRRC's data base entitled Corporate Takeover Defenses, cover 10 types of protections that are consistently reported across the IRRC 1,500-firm universe. They are (1) supermajority amendments; (2) poison pills; (3) "stakeholder" provisions permitting directors to consider nonfinancial aspects of takeovers; (4) blank-check preferred stock authorizations; (5) unequal voting rights plans, such as dual-class capital structures; (6) classified board plans; (7) amendments to eliminate cumulative voting; (8) amendments to limit or eliminate shareholders' right to act by written consent; (9) amendments to limit or eliminate shareholders' right to call special meetings; and (10) lock-in provisions, requiring a supermajority to change any provision of the charter or bylaws. Ownership data are drawn from Compustat, Standard and Poor's Security Owners' Stock Guide, Spectrum's Ownership Profiles, and proxies.

For economic, governance, and ownership data, the statistical tests compare the average performance of firms opting out of SB 1310 to that of firms choosing not to opt out of the law. For each variable, an average is calculated for four samples of firms. They are firms that chose not to opt out of any provisions of SB 1310; all firms that chose to opt out of at least one provision of 1310; firms that chose to opt out of all provisions of the law; and firms that chose to opt out of the control share and disgorgement provisions, but not the fiduciary provision. (For the governance structure comparisons, that latter group is expanded to include a small number of firms opting out of control shares only or disgorgement only, in order to expand this smaller sample.) Averages are then compared to test for systematic differences. For governance data the same approach is followed but frequencies instead of averages are used. For ownership the approach is once again parallel, but medians are used because of the poor distribution of the ownership data.

4. Results

In Tables 1–5, I present evidence on corporate governance structure, economic performance, and ownership structure for firms opting out and not opting out of SB 1310. In Table 1, I present a comparison of corporate governance records. In Table 2, I present data on long-term accounting performance. In Table 3, I present data on spending behavior and corporate resources. In Table 4, I present data on financial performance—stock returns and valuation. In Table 5, I present data on ownership structure.

The results in Table 1 show a striking difference in the pre-existing governance structure between firms opting out of some or all portions of SB 1310 and firms not opting out of any of its provisions. Firms not opting out of the law display a much higher frequency of pre–SB 1310 poison pill adoptions than do firms opting out of its protections. Over 75 percent of not-opting-out firms had a pill in place at the time of the opt-out decision; only 26 percent of firms opting out of some or all provisions of the law had such a provision in place. Among firms opting out of all of 1310's provisions only 18 percent had pills, while among firms opting out of some but not all provisions of the law, 30 percent had pills.

Significant differences are not evident among other major takeover protections, which are in the form of charter amendments that would have required voting approval by shareholders. Sixteen percent of firms not opting out of 1310 had pre-existing supermajority provisions, compared to 26 percent of opting-out firms; 15 percent of not-opting-out firms had some form of unequal voting plan, compared to 16 percent of opting-out firms; and 62 percent of not-opting-out firms had a classified board, compared to 61 percent of opting-out firms. The only significant difference among non–poison pill protections is found in the frequency of lock-in provisions, which were present in none of the not-opting-out firms, compared to 26 percent of the opting-out firms. (It should be noted that IRRC's data may not be as reliable on lock-in provisions, which may be long-standing or attached as a component of a supermajority plan. Accuracy is high with respect to major protections including poison pills, supermajorities, unequal voting plans, blank-check preferred, nonfinancial effects provisions, and classified boards.)

These data suggest repeat behavior in the search for takeover protections that do not require shareholder approval. They show that among Pennsylvania-incorporated firms, one set repeatedly sought takeover protections that could be secured without a shareholder vote—including poison pills and the Pennsylvania law—while another set of firms did not. Few firms lie in the middle, availing themselves of one non-voting protection but not the other.

The data in Table 2 compare the long-run accounting performance of opting-out and not-opting-out firms across three popular measures of long-run accounting performance: operating margin, return on assets, and asset turnover. Firms opting out of all of 1310's provisions display slightly higher performance across these measures than do firms opting out of some provisions, and than firms not opting out of any provisions. The data do not show a

Table 1. Governance Structure

Group	Poison Pill	Blank-Check Pref.	Super-majority	Unequal Voting	Nonfinan. Effects of Merger	Classif. Board	Elim. Cumulat. Voting	Elim./Limit Written Consent	Elim./Limit Special Meetings	Lock-in Supermaj. to Amend Charter/Bylaws
Not Opting Out $N = 13$	0.77*	0.85	0.15	0.15	0.00	0.62	0.08	0.00	0.23	0.00*
All Opt-outs (Opting Out of at Least One Provision) $N = 38$	0.26	0.79	0.26	0.16	0.13	0.61	0.11	0.05	0.11	0.26
Opt Out of All Provisions $N = 11$	0.18	0.73	0.09	0.18	0.00	0.36	0.00	0.00	0.18	0.27
Opt Out of Some But Not All Provisions N = 27	0.30	0.81	0.33	0.15	0.19	0.70	0.15	0.07	0.07	0.26

Data are presented on the governance structure of Pennsylvania-incorporated firms opting out of some, all, or no provisions of Pennsylvania's takeover law, SB 1310. Statistics denote the frequency of each type of protection within each subsample of firms at the end of the year prior to enactment of the law. Sample is 51 Pennsylvania-incorporated firms included in the IRRC's annual data base entitled Corporate Takeover Defenses (IRRC, 1990).

*Rejection of null hypothesis that value is the same for firms not opting out of any provisions and pooled sample of all firms opting out of some portion of the law at 5% level in a two-tailed binomial proportions test.

Table 2. Long-term Performance

Group	Operating Margin	Return on Assets	Asset Turnover
Not Opting Out $N = 28$	.65 (.06)	.65 (.06)	.56 (.06)
All Opt-outs (Opting Out of at Least One Provision) $N = 70$	.64 (.04)	.63 (.04)	.51 (.03)
Opt Out of All Provisions $N = 26$	.70 (.06)	.68 (.06)	.46 (.06)
Opt Out of Control Share and Disgorgement Provisions Only $N = 36$	.59 (.05)	.56 (.05)	.53 (.04)

Summary statistics are presented on the long-run (five-year average) accounting performance of Pennsylvania-incorporated firms opting out of some, all, or no provisions of Pennsylvania's takeover law, SB 1310. Statistics denote the average percentile occupied by each sample of firms, relative to their industry peers as defined by their four-digit SIC codes. Performance is measured over the five-year period ending the year prior to enactment of SB 1310. Sample is 98 Pennsylvania-incorporated firms with performance data on Compustat. Standard errors are in parentheses.

significant difference between all firms that opted out of at least one part of SB 1310, viewed as a group, and those firms that did not opt out of any parts of the law.

These data do not strongly suggest that the opt-out decision was driven by differences in long-run historical performance. This, in turn, argues against the theory that takeover pressures accumulate against firms with poor historical performance, and that these performance-caused pressures drive firms to seek protections. Firms opting out of all parts of SB 1310 appear to be somewhat stronger performers, but the result is marginal and the differences are small.

The data in Table 3 compare opting-out and not-opting-out firms across measures of corporate resources, spending, investment, and cost control. There are no significant differences between not-opting-out firms and all opt-outs in the level of internal corporate resources, measured by the size of cash flows relative to assets (or, indeed, as measured by return on assets, as in Table 2). Firms opting out of all of SB 1310's provisions display slightly higher cash flows, but the difference is not significant. Similarly, there are no differences in the level of resource expenditures on investment, including capital spending or research and development. Firms opting out of all of SB 1310's provisions display slightly lower industry-adjusted capital spending, measured as a percent of assets in place, but once again, the difference is not significant. Nor are there significant differences in cost structure. Firms opting

Table 3. Resources, Investment, and Spending

Group	Cash Flow/Assets	R&D/Sales	Capex/Sales	Capex/Assets	SG&A/Sales	Cogs/Sales
Not Opting Out $N = 28$	.66 (.06)	.64 (.08)	.51 (.07)	.56 (.07)	.53 (.08)	.51 (.06)
All Opt-outs (Opting Out of at Least One Provision) $N = 70$	.65 (.04)	.60 (.06)	.56 (.04)	.55 (.04)	.48 (.04)	.54 (.04)
Opt Out of All Provisions $N = 26$	.71 (.05)	.69 (.04)	.53 (.06)	.46 (.07)	.47 (.07)	.52 (.07)
Opt Out of Control Share and Disgorgement Provisions Only $N = 36$	.59 (.05)	.56 (.09)	.55 (.05)	.54 (.05)	.49 (.06)	.56 (.05)

Summary statistics are presented on the long-run (five-year average) research and development and capital spending decisions, cost structures, and cash flows of Pennsylvania-incorporated firms opting out of some, all, or no provisions of Pennsylvania's takeover law, SB 1310. Statistics denote the average percentile occupied by each sample of firms, relative to their industry peers as defined by four-digit SIC codes. Performance is measured over the five-year period ending the year prior to enactment of SB 1310. Sample is 98 Pennsylvania-incorporated firms with performance data on Compustat. Standard errors are in parentheses.

*Rejection of null hypothesis that value is the same for firms not opting out of any provisions and pooled sample of all firms opting out of some portion of the law at 5% level in a two-tailed test.

Table 4. Financial Performance

Group	Payout Ratio	Earnings/ Price	Cash Flow/ Price	1-Year Return	LR Return
Not Opting Out	.62*	.72*	.67	.73*	.62
$N = 28$	(.05)	(.05)	(.04)	(.04)	(.06)
All Opt-outs (Opting Out	.51	.61	.61	.58	.54
of at Least One	(.04)	(.03)	(.03)	(.03)	(.06)
Provision)					
$N = 70$					
Opting Out of All	.42	.65	.60	.62	.53
Provisions	(.05)	(.05)	(.05)	(.05)	(.04)
$N = 26$					
Opting Out of Control	.58	.59	.63	.56	.55
Share and Disgorgement	(.06)	(.04)	(.03)	(.04)	(.06)
Provisions Only					
$N = 36$					

Summary statistics are presented on industry-adjusted stock returns, valuation, and payout ratios for Pennsylvania-incorporated firms opting out of some, all, or no provisions of Pennsylvania's takeover law, SB 1310. Statistics denote the average percentile occupied by each sample of firms, relative to their industry peers as defined by four-digit SIC codes. Payout ratio is the average obtaining over the five-year period ending the year prior to enactment of SB 1310. Valuation ratios are measured at the end of the calendar year prior to adoption of SB 1310. One-year stock return is measured over the calendar year prior to adoption; LR return is measured over the four years preceding the pre-adoption year to avoid the use of a common endpoint. Sample is 98 Pennsylvania-incorporated firms with performance data on Compustat. Standard errors are in parentheses.

*Rejection of null hypothesis that value is the same for firms not opting out of any provisions and pooled sample of all firms opting out of some portion of the law at 5% level in a two-tailed test.

Table 5. Ownership Concentration

Group	Median Insider Ownership (%)	Median Institutional Ownership (%)	Median Noninstitutional Blockholder (%)	Median Institutional Blockholder (%)
Not Opting Out $N = 32$	6.9*	44.2	0.0	5.9
All Opt-outs (Opting Out of at Least One Provision) $N = 92$	13.4	42.3	0.8	7.1
Opting Out of All Provisions $N = 32$	17.7	32.5	0.7	8.5
Opting Out of Control Share and Disgorgement Provisions Only $N = 50$	12.9	43.6	1.0	6.4

Summary statistics are presented on insider, blockholder, and institutional ownership for Pennsylvania-incorporated firms opting out of some, all, or no provisions of Pennsylvania's takeover law, SB 1310. Insider and blockholder ownership is reported for 124 firms based on information in proxies. Institutional ownership is reported for 89 firms with data available in Standard and Poor's Sources.

*Rejection of null hypothesis that median value is the same for firms not opting out of any provisions and pooled sample of all firms opting out of some portion of the law at 5% level.

out of all of SB 1310's provisions display slightly lower SG&A costs than firms not opting out, but the difference is not statistically significant.

These data suggest that the opt-out decision—or, conversely, the decision to seek protection under SB 1310—was not driven by large and systematic differences in either the average level of internal corporate resources or in the level of commitment of these resources to internal investment and production. Firms not opting out of the law do not display a higher level of long-term investment as some takeover opponents might argue would be the case; nor, however, do they display a high level of resources relative to their asset base. Instead, firms are roughly comparable across the various measures.

The data in Table 4 compare the financial performance—stock returns and valuation—of firms opting out of SB 1310 and those not opting out of the law. Systematic differences between opting-out and not-opting-out firms are revealed. Firms opting out of SB 1310 are valued more highly by the market, in terms of the premium placed on currently generated internal corporate resources. Opting-out firms have significantly lower earnings—price multiples or, in the more common parlance, higher price–earnings ratios. Price-to-cash-flow ratios show the same direction and marginal (10 percent) significance. Concurrently, firms opting out of SB 1310 have lower one-year stock returns than do firms not opting out of the law. Firms opting out of the law also have lower payout ratios than firms remaining covered by SB 1310.

These data suggest that firms that did not opt out of SB 1310 were characterized by lower market confidence in future results than was the case for firms that opted out of SB 1310. Lower confidence in future results inferentially suggests lower confidence in management's current investment decisions—the use that is presently being made of existing corporate resources. This is consistent with the hypothesis that takeover pressure occurs against firms that are making poor current investment decisions, and that these firms seek protection to escape that pressure. The lower payout ratio of opting-out firms is also interesting given their higher valuation. It suggests that the market is more confident of investment decisions at these firms, and hence not only values these firms more highly but is also content to allow management more discretion over the use of resources.

The positive stock price performance of firms not opting out of SB 1310 may be due to several factors. First, it is possible that some firms not opting out of the law had been the subjects of takeover speculation in the year prior to the opt-out decision, which would cause high returns for the not-opting-out group. This was true, for example, of Armstrong World Industries, which was the original motive force behind the legislation. Second, it is possible that not-opting-out firms had experienced a positive performance surprise in the recent past—for example, better-than-expected earnings—and that the valuation discount on these firms reflected market concern about the disposition of this growing resource base. Third, it is possible that the difference observed derives from differences in systematic risk and hence in expected returns. This is unlikely, however, because the industry adjustment of returns tends to control for risk class in a manner roughly equivalent to and sometimes better than broad measures such as beta.

The data in Table 5 compare the ownership structure of firms opting out and not opting out of SB 1310. Data cover ownership by insiders, defined as officers and directors as a group; institutional ownership; ownership by non-institutional outside blockholders, who are not represented on the board; and block ownership (over 5 percent of common shares) by institutions. A significant difference between opting-out and not-opting-out firms in the median level of inside ownership is revealed. Opting-out firms display higher median inside ownership, at approximately 13.5 percent, compared to the 6.9 percent median ownership level displayed by firms not opting out of SB 1310. This suggests that at firms opting out of the law, management enjoyed both higher performance incentives and greater structural protection from outside pressure than at those firms not opting out. The greater ownership incentives for these firms are consistent with the higher average valuation ratios of this group of firms. Similarly, the greater protection conveyed by higher insider ownership is consistent with the relatively lower frequency of poison pill adoptions.

There are no meaningful differences between opting-out and not-opting-out firms across the other dimensions of ownership structure reported in Table 5. Median institutional ownership, at 42.3 percent for opting-out firms, is roughly the same as the 44.2 percent median ownership found at firms not opting out. Block ownership by institutions and by outside noninstitutions is similar as well.

5. Conclusion

In this article, I present data on the financial, economic, corporate governance, and ownership characteristics of firms that chose to opt out of, or remain covered by, Pennsylvania's new takeover statute, SB 1310. SB 1310 created a natural control experiment in which a large number of firms self-selected into different corporate governance structures in a limited period of time and without the need for shareholder approval. Differences between firms choosing to be covered by the law and those choosing to recuse themselves provide inferential evidence on the motives for adopting different corporate governance structures.

The data in this article reveal that firms not opting out of SB 1310 are different along several important dimensions. Firms not opting out of the law were much more likely to have adopted a poison pill takeover defense. They were also valued at a lower level by the market, relative to their industry peers, compared to firms opting out of some or all provisions. Firms not opting out had higher payout ratios and better recent stock price performance than did opting-out firms. Not-opting-out firms had lower median levels of insider ownership than did firms recusing themselves from some or all parts of SB 1310.

In contrast to these differences in financial performance, ownership structure, and governance record, the data reveal no systematic differences between opting-out and not-opting-out firms across a wide variety of measures of historical economic performance. Differences were not evident on long-term efficiency measures including return on assets, asset turnover, or operating margin. Nor were differences evident in the amount of internal corporate resources, measured either as profitability relative to assets or cash flow as a percentage of assets. Nor were there differences in long-term investment expenditures, including research and development and capital spending, or in cost control, measured by SG&A costs or cost of goods sold.

Viewed broadly, these data help to distinguish between competing hypotheses about why firms seek more restrictive corporate governance structures, particularly ones such as state laws and poison pills that are secured without a shareholder vote. Several theories do not receive support in the data. They include the hypotheses that firms adopt governance structures for idiosyncratic contracting reasons; that firms seek protection so as to be able to engage in high levels of long-term investment; that firms seek protection to secure discretion in the use of unusually high levels of internal corporate resources; and that firms seek protection because of a sustained record of poor historical performance that has rendered them vulnerable to a proxy contest or takeover bid.

Instead, the data appear most consistent with the theory that protections are sought by firms that have a higher level of principal–agent slack, that are making poor decisions with current resources (whatever their level), and that are consequently undervalued by the market. The undervaluation of firms not opting out of SB 1310 suggests that the market is not confident about how these managements will use corporate resources. The lower payout ratio of firms opting out of SB 1310 reinforces this hypothesis, indicating that the market was more confident of investment decisions at these firms, and hence not only valued them more highly but was also content to allow management more discretion over the use of resources. The higher frequency of poison pill adoptions among non-opting-out firms suggests a persistent quest for protection on the part of these firms, probably in response to low valuation and market confidence. Lower insider ownership for not-opting-out firms further reinforces this composite picture, suggesting worse incentive structures and thus a greater tendency to make mistakes with internally generated resources.

Together, thus, these data combine to suggest a lower level of incentives and expected future performance at firms choosing to remain covered by the law and a resulting quest for protection from market pressures. The result is not a record of poor past performance, but rather an expectation of reduced future performance. Interestingly, recent empirical evidence on the post-adoption long-term performance of firms with more restrictive corporate governance structure provides further support for and extends this picture, showing that firms that adopt more restrictive corporate governance structures do in fact turn in lower long-term fundamental performance in the long term after protections are in place (Gordon and Pound).

These results complement the pre-existing literature on the effects of state takeover laws. That literature, examining the stock price effects of these statutes on affected companies, suggests that state takeover statutes protect managerial authority at the expense of shareholders' ability to exercise market discipline (Karpoff and Malatesta, 1989). The literature on Pennsylvania in particular suggests that the law depressed share prices (Karpoff and Malatesta, 1990; Szewczyk and Tsetsekos). The evidence in this article is consistent with those results, providing a supporting perspective on the motives of those managers choosing to opt out and not to opt out.

The data also complement the broader literature on firm-specific governance protections, which, as discussed in Section 2, is broadly inconsistent with the hypothesis that such protections are in the best interests of shareholders. The results in this article extend previous work by documenting that takeover protections appear to be sought by firms with relatively lower internal incentive structures and lower valuation, suggesting that the motive for adoption is to secure protection from external market pressures. In addition, the data confirm a recurring pattern of adoption of nonvoting takeover protections by firms with weaker internal incentive structures.

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