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The Classified Board Duels

Professor Lucian Bebchuk has engaged in two rounds of law-review-article duels with Professor Martijn Cremers and Professor Simone Sepe over classified boards. The weapons were statistics (and common sense). Cremers and Sepe wore the classified-board-stakeholder colors; Bebchuk, the agency-model-shareholder-democracy colors. Cremers' and Sepe's riposte was decisive.

The field for these duels was chosen by Bebchuk in 2011 when he chartered the Harvard Law School Shareholder Rights Project (the "Harvard Project"). Bebchuk described the Harvard Project as an academic program designed to "contribute to education, discourse, and research related to efforts by institutional investors to improve corporate governance arrangements at publicly traded firms." In practice, it worked to eliminate the classified-board moat protecting companies from short-termism and attacks by activist hedge funds. Over the course of three academic years from 2011 to 2014, the Harvard Project submitted declassification proposals to 129 companies, resulting in 102 declassifications.

Bebchuk's Harvard Project sparked sharp criticism. Former SEC Commissioner Daniel Gallagher's and Stanford Professor Joseph Grundfest's *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* (2014) argued that it "relie[d] on the categorical assertion that staggered boards are associated with inferior financial performance" and that the proposals omitted disclosure of significant, conflicting research.

Scholars with sharpened statistics followed suit. Cremers' and Sepe's *The Shareholder Value of Empowered Boards* (2016), as well as their follow-on piece *Staggered Boards and Long-Term Firm Value, Revisited* (2017) coauthored with Lubomir Litov, employed lengthy time-series studies showing that classification (declassification) is associated with an increase (decrease) in firm value. These studies exposed the limitations of prior cross-sectional studies: namely Bebchuk's *The Costs of Entrenched Boards* (2005), which succumbs to the reverse causality fallacy. They provided "no support for the entrenchment view." In light of their findings, the authors urged policy reform to make classification boards quasi-mandatory, exclude shareholder declassification proposals and impose a supermajority requirement on board declassification proposals. They believed this reform would "restore a board's ability to credibly commit shareholders to long-term value creation, which is in their own and society's best interests."

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Cremers and Sepe then turned to the Harvard Project. *Board Declassification Activism: The Financial Value of the Shareholder Rights Project* (2017) treated the Harvard Project as a "quasi-natural experiment" to again measure value implications of classifications. These data provided a source of exogenous variation, useful to avoid the flaws in prior cross-sectional studies, because the Harvard Project plausibly had "a direct, causal impact" on classification decisions. And the results remained the same. They found that Harvard Project targets that declassified declined in value, more so than non-Project targets, and that such declines appeared "directly attributable to . . . declassification." Further, these results were especially strong for firms with large research and development investments. Consistent with recent studies, they concluded that "classified boards may serve a positive governance function in some companies, thus challenging the 'one-size-fits-all' approach to board declassification exemplified by the [Harvard Project] and, more generally, most activist investors and proxy advisory firms."

In *Recent Board Declassifications: A Response to Cremers and Sepe* (2017), Bebchuk and Alma Cohen contend that, "appropriately interpreted," Cremers' and Sepe's 2017 study contradicts their own 2016 study because it "provide[s] some significant evidence that declassifications are beneficial and no evidence that they are value-reducing." Bebchuk and Cohen focus on non-Project declassifications, which they believe are more important than Project declassifications (reasoning that the Harvard Project was limited in time and scope), and claim that firm values did not decline after non-Project declassifications. They turn only briefly to Project declassifications, finding that the results do not "provide a basis for concluding that [such] declassifications reduced value." Bebchuk and Cohen conclude that the results "fail to provide any basis for opposing declassifications," which justifies the apparent retreat from the policy proposal in the 2016 article (*i.e.*, the relatively weaker language in the 2017 article).

In response to Bebchuk and Cohen, Cremers' and Sepe's *Board Declassification Activism: Why Run Away from the Evidence?* (2017) reiterates their findings and argues that Bebchuk's and Cohen's critique is unwarranted because, put simply, it ignores the evidence. That is, the critique essentially disregards the main result that firm values declined after Project declassifications; cherry-picks data, sidestepping or downplaying key results; draws conclusions on statistically and economically insignificant results, defying the "basic econometric precept that no inferences can be drawn when results lack statistical significance" and incorrectly focuses on non-Project declassifications while failing to interpret them in connection with Cremers' and Sepe's prior studies. Finally, Cremers and

Sepe show that their 2017 study reinforces, and not belies, their policy proposal with new data: a $90 to $149 billion decline in value associated with Project declassifications that their policy would have mitigated "if not altogether prevented."

The costs of Bebchuk's actions are real. He has exposed hundreds of major U.S. companies to short-term pressures and attacks by activist investors to the detriment of those companies, their shareholders and, more generally, the economy. With the growing recognition by major institutional investors, asset managers and academics that short-termism and activism are antithetical to the interests of all stakeholders, including shareholders, and society generally, one hopes that Bebchuk and his cohorts would cross the Charles River and join their Harvard Business School colleagues, Jay Lorsch, William George, Joseph Bower and Lynn Paine in supporting long-term investment and rational, not shareholder-only, governance. In a recent article, Bower and Paine sum up the damage done by one-size-fits-all, shareholder-centric governance:

> To us, the prospect that public companies will be run even more strictly according to the agency-based model is alarming. Rigid adherence to the model by companies uniformly across the economy could easily result in even more pressure for current earnings, less investment in R&D and in people, fewer transformational strategies and innovative business models, and further wealth flowing to sophisticated investors at the expense of ordinary investors and everyone else.

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