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Underperformance of founder-led firms: An examination of compensation contracting theories during the executive stock options backdating scandal

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ABSTRACT

Using the executive stock option (ESO) backdating scandal as a backdrop, this paper examines whether compensation committees can effectively set executive compensation contracts in the presence of a founding CEO. Analyzing a sample of firms accused of backdating ESO grant dates and a control sample of non-backdating firms, we find evidence suggesting that managerial power influences the decision to backdate. Specifically, our analysis indicates the presence of a founder CEO increases the likelihood that ESOs are backdated by 22%. We further find that founder-led firms strongly underperform a matched sample of non-backdating firms. This finding contrasts a number of studies that document superior operating and stock return performance for founder-led firms.

1. Introduction

Executive compensation contracts represent vital corporate governance mechanisms necessary to confront agency costs that arise due to the separation of ownership and control (Gillan, 2006; Grossman and Hart, 1983; Jensen and Meckling, 1976). In an optimal contracting setting, these compensation contracts align managerial interests with those of the shareholders, thereby incentivizing managers to maximize firm value for the benefit of the shareholders (Grossman and Hart, 1983; Jensen and Murphy, 1990). Managerial power or entrenchment can, however, allow for rent extraction via excess compensation and often coincides with disappointing operating and stock performance to the detriment of the firms' shareholders (e.g., Bebchuk and Fried, 2004; Bebchuk et al., 2002). In this paper, we examine these theories as they relate to executive compensation practices within the context of the backdating scandal of 2006–2007.

Executive stock option (ESO) grants are a core component of many compensation plans and are often used as a means of aligning the interests of top management with those of the shareholders. These options are typically granted at the money and, therefore, qualify as performance based compensation. Lie (2005) and Heron and Lie (2007), however, present evidence suggesting that some firms may have systematically engaged in the practice of retroactively assigning option grant dates to take advantage of prior stock price movements. Such actions provide top management with additional compensation at the expense of

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current shareholders and potentially invalidate the deductibility of those option grants under Section 162(m) of the Internal Revenue Code. If the deductibility of the grants is lost, firms could face penalties from the IRS, leading to financial restatements and subsequent litigation against the corporation. As a result of this practice, 39 securities class-action lawsuits have been filed, highlighting the risks associated with the backdating of ESO grant dates.[1]

Executive compensation (including ESOs) is set by the compensation committee of the board of directors. While the shareholders of a corporation must approve a stock option plan, the compensation committee has significant latitude in determining the details of individual ESO grants. Accepting the risks associated with the practice of backdating, therefore, suggests either 1) the compensation committee, through economic analysis, determined that the inclusion of backdated options in the compensation package provides benefits to shareholders that exceed the cost of being caught engaging in the practice or 2) managers are able to exert influence over the compensation committee to allow for rent extraction.

The suggestion that backdated options provide net benefits to the firm and are, thus, part of an optimal contracting solution is derived from the agency theory of the firm (Jensen and Meckling, 1976). Under this theory, performance based compensation aligns the incentives of the manager and shareholders and, thus, mitigates agency concerns. This, however, has not been observed consistently in practice (Baker et al., 1988; Yermack, 1995). To the contrary, recent studies have documented an inverse association between the strength and effectiveness of a firm's corporate governance and executive compensation (Collins et al., 2009; Core et al., 1999; Lee et al., 2010). Further, Morse et al. (2011) find that powerful CEOs are able to structure their compensation contracts to disguise their extraction of excess rents.

While the literature has consistently established an association between "weak" governance characteristics and executive compensation, Raheja (2005), Coles et al. (2008) and Linck et al. (2008) suggest that governance structures are endogenously chosen in response to firm specific circumstances. Bushman (2009) advances this point suggesting that the observed relations between governance and executive compensation in the prior literature, and specifically in the options backdating literature, represent attempts to address firm-specific agency issues in arriving at an optimal second-best contracting solution. As a result, the granting of backdated stock options may very well represent an attempt by compensation committees to establish optimal contracts in the real-world where purely optimal solutions are rarely attainable.

To examine these competing compensation theories, we construct a sample of firms accused of backdating option grant dates based on reports prepared by *The Wall Street Journal*, Glass, Lewis & Co., and the securities law firm Kahn Gauthier Swick, LLC. Using these sources, we identify 182 firms under investigation for ESO backdating in the year 2000 to comprise our test sample.[2] The control sample consists of the 1273 ESO granting firms included in the Risk Metrics governance database for the same year that have not been accused of ESO backdating.

The construction of our sample creates challenges in the empirical analysis, since we are only able to observe those firms that have been accused of backdating options. As a result, we are not able to directly observe the probability that a firm engages in the practice of backdating stock option grant dates. To address this problem, we use a bivariate probit model with partial observability to examine the determinants of both options backdating and the detection of this behavior (Wang, 2011). Our findings, like those of Collins et al. (2009), Bebchuk et al. (2010), and Lee et al. (2010), suggest that firms engage in a cost–benefit analysis regarding the decision to backdate. Our results, however, imply that this analysis is used by management to backdate options opportunistically in order to derive personal benefits through rent extraction. Specifically, we identify a significant, positive relation between the propensity to backdate ESO grant dates and the pay-for-performance sensitivity of the CEO and a significant, negative relation between the propensity to backdate and both the maturity of the CEO's option grants and the dividend yield. Furthermore, the presence of a founding CEO is significantly related to backdating.

Our results also indicate the probability of detection is increasing in sales growth and is higher when the firm is led by a founding CEO. This latter result suggests that not only does managerial power influence the decision to backdate, but it also increases the probability that the backdating is detected and formal accusations are leveled.

In a scenario where managerial power provides the impetus to backdate, managers may lack the incentive to protect shareholder wealth. Motivated by the fact that founder-led firms represent approximately one-third of the firms under investigation for backdating, our next set of analyses focuses on stock market and operating performance measures for the sample of firms accused of backdating ESO grant dates. Our results indicate that the subsequent stock price performance for the full sample of backdating firms is significantly negative only by the third year following the alleged backdating. However, for the subsample of backdating firms managed by a founding CEO, we observe significant negative abnormal returns over each of the three years following the alleged backdating, suggesting that founder-led backdating firms underperform. Consistent with future stock market performance, we show that firms led by a founding CEO display poor operating performance in both the year of the alleged backdating and in the subsequent year. Collectively, these results demonstrate that the shareholders of firms with a founding CEO suffer a significant decline in performance as a result of compensation committee ineffectiveness. These findings suggest that the observed underperformance by backdating firms may be primarily attributed to founder-led firms.

Our observation of significant underperformance within founder-led firms is particularly notable given that prior literature indicates that founder-led firms provide superior performance (Adams et al., 2009; Anderson and Reeb, 2003; Fahlenbrach, 2009; Villalonga and Amit, 2006). Therefore, we compare our sample of founder-led backdating firms to other backdating firms, as well as to founder-led firms that were not accused of backdating. Comparisons suggest that founder-led backdating firms are smaller

[1] Twenty-eight of these cases have been settled for an average $83 million and eight cases have been dismissed (Savett, 2010).

[2] After regulation in 2002 altered the reporting of ESO grants, the practice of backdating was severely curtailed, resulting in few cases of options backdating after 2001 (Heron and Lie, 2007).