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Strategically camouflaged corporate governance in IPOs: Entrepreneurial masking and impression management☆

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ABSTRACT

Entrepreneurs attempt to persuade potential investors that their new ventures are both credible and worthy of funding. A long line of research on entrepreneurial impression management establishes that the ability to present their ventures in a favorable light is a key attribute of successful entrepreneurs. In this study, we examine the opposite side of the issue and test to determine if some entrepreneurs obscure corporate governance information. We create a new metric to measure the level of camouflage used in governance documents for initial public offerings (IPOs). We find that entrepreneurs are less likely to use camouflage during periods of high scrutiny, as measured by industry analyst following, industry concentration levels, and IPO clustering. We also find that greater use of camouflage is associated with raising more capital, due to both greater offer proceeds as well as less underpricing. This effect is most pronounced in corporate charters which are difficult for shareholders to change.

1. Executive summary

Entrepreneurs attempt to persuade potential investors that their new ventures are both credible and worthy of funding. Consequently, a long literature in entrepreneurship has focused on the behaviors and strategies that entrepreneurs employ to present their ventures in the most favorable light.

Much of this research draws on psychological research regarding impression management (IM) strategies. To date, however, the entrepreneurship literature has focused primarily on the positive IM behaviors—for example, how entrepreneurs can use language and symbolic action to demonstrate their passion for and confidence in their new ventures. However, the broader psychological IM literature has also identified a number of negative (and often deceptive) behaviors that individuals use to create or maintain a positive impression (e.g. downplaying, omitting, embellishing, and masking). Indeed, a consistent finding in the broader psychological literature on IM is that individuals are more likely to use deception when the stakes are high and being viewed positively is crucial to the outcome. Thus, the lack of prior research on these behaviors is surprising given that entrepreneurial fundraising would seem to be *precisely* the type of high stakes event in which deception would likely be used.

In this paper, we focus on camouflage, or the use of overly complex or technical language designed to make a document less transparent. We do so by examining the language entrepreneurs adopt to describe their corporate governance within their charters and by-laws. Specifically, we examine two key questions: (1) do firms that adopt less investor-friendly governance structures (e.g. staggered

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boards and limits to shareholder amendments) utilize more camouflage in their charters and bylaws? And (2) does the use of such camouflage affect market outcomes?

We use textual analysis to measure the textual complexity, tone, and overall readability (which together we call camouflage) of the corporate charters and bylaws of 1665 IPOs completed between 1995 and 2011.

We find the following key results:

- First, IPO firms that have less investor-friendly governance provisions employ more obfuscation in their charters and bylaws.
- Second, this effect is attenuated for firms that expect to face greater scrutiny—for example, firms whose actions are followed by more analysts.
- Third, for two similarly-situated firms with the same level of entrenchment, the IPO firm that utilizes more camouflage in its governance documents suffers less underpricing and raises more capital. Moreover, these effects are more pronounced when the camouflage is used in the difficult-to-change corporate charter. (Bylaws can be amended unilaterally by a majority vote of shareholders; for charters, even after a majority vote the amendment still requires board approval. Thus, placing an entrenching provision in the charter results in significantly greater protection for management.)

Taken together, our results suggest that the use of camouflage by IPO firms in describing their corporate governance is an important, but understudied behavior, and that its use can affect important market outcomes.

2. Introduction

Gathering resources, particularly funding, for a startup is one of the most challenging tasks facing entrepreneurs. Indeed, some have described it as *the* defining challenge of entrepreneurial founders (Brush et al., 2001). Hence, a primary focus of entrepreneurial research has emphasized identifying the attributes and actions of entrepreneurs that enable them to successfully gather resources for their startup (Überbacher, 2014; Venkataraman, 1997). Some of these factors include the caliber of the founding team (Colombo and Grilli, 2005; Cooper et al., 1994; Hsu, 2007), the reputation of affiliated partners (Higgins and Gulati, 2003; Stuart et al., 1999), the social capital of the founders (Florin et al., 2003; Shane and Cable, 2002), and participating in certification contests (Rao, 1994).

More recently, scholars have focused on the use of impression management (IM) strategies, particularly language and symbolic action, by entrepreneurs and their impact on the entrepreneurs' ability to raise funds (Lounsbury and Glynn, 2001; Martens et al., 2007; Parhankangas and Ehrlich, 2014; Zott and Huy, 2007). Although the broader psychological research on impression management has identified both positive and negative actions that individuals could use (Bolino et al., 2008; Leary and Kowalski, 1990; Levashina and Campion, 2007), the entrepreneurship literature on IM has largely focused on the positive—how entrepreneurs can "put their best foot forward" or "accentuate the positive" (Hoehn-Weiss et al., 2004). In this paper, we examine the flip side of the coin—do entrepreneurs take steps to conceal or camouflage corporate governance information? And if so, does it work? In other words, do entrepreneurs who use camouflage gain more resources than those who do not?

We combine insights from the broader psychological literature on impression management with contributions from the accounting literature on management obfuscation to develop hypotheses regarding when and how entrepreneurs will use camouflage. We focus on the language the entrepreneurs use to describe their corporate governance within their corporate charter and bylaws.

We test our propositions by examining the corporate governance documents of 1665 IPOs issued between 1995 and 2011. In the aggregate, we find support for our hypotheses: entrepreneurs are more likely to camouflage governance information when they face less scrutiny, and they appear to be rewarded for their efforts. Specifically, entrepreneurs are less likely to camouflage governance the more analysts that follow them and in periods when there are few other IPOs (with which they can blend in). More importantly, we find evidence that such camouflage seems to work—camouflaged IPOs raise more funds and experience less underpricing.

This research makes at least three contributions to the prior literature. First we contribute to the literature on entrepreneurial impression management. Only recently have scholars examined the role of concealment or deception by entrepreneurs (Pollack and Bosse, 2014; Rutherford et al., 2009). Thus, this study answers calls for research that examines a broader array of IM behaviors, and particularly the use of concealment or obfuscation by entrepreneurs (Lounsbury and Glynn, 2001; Martens et al., 2007). Indeed, as Martens et al. (2007) explain:

> "*One of the most obvious* [directions for future research] *is the need to investigate the nature, prevalence, and effects of inauthentic entrepreneurial narratives…. To what extent do entrepreneurs engage in these and other forms of 'poetic elaboration' when telling stories about their endeavors? Do recipients accept inauthentic narratives as 'prerogatives of poetic license' or do they deem them to be 'misrepresentations, untruths, and lies?' And even if investors do not wholly believe certain narratives, does that prevent them from committing capital?*" (p. 1126).

Thus, we advance the extant research by examining the nature and effects of one form of "inauthentic entrepreneurial narrative"—the use of camouflage by entrepreneurs.

Second, we also contribute to the broader work on entrepreneurial corporate governance. A long line of research has established that corporate governance matters in a firm's performance, and that firms with more entrenched management underperform firms with more shareholder-friendly governance (Bebchuk and Cohen, 2005; Bebchuk et al., 2009; Gompers et al., 2003). Some have questioned whether such agency conflicts are equally severe in entrepreneur-managed firms (Wasserman, 2006), arguing that the stewardship that the entrepreneur feels towards her firm may mitigate some of the traditional agency concerns (Gao and Jain, 2012). Our results suggest that investors should proceed with caution before lowering their guard.