

RESISTANCE AND ACCOUNTABILITY

ADVANCES IN PUBLIC INTEREST ACCOUNTING

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MANAGEMENT ENTRENCHMENT AND STOCK OPTION BACKDATING

Nana Y. Amoah, Isaac Bonaparte,
Ebenezer K. Lamptey and Muni Kelly

ABSTRACT

Using the [L. Bebchuk, Cohen, and Ferrell \(2009\)](#) entrenchment index (E-index), the authors examine the relation between management entrenchment and the probability of a firm being implicated in the stock option backdating scandal. The authors conduct the analysis of this study using logistic regression, and they document a negative relation between the E-index and the probability of a firm being implicated in the stock option backdating scandal. The results of this study are consistent with the view that management entrenchment is advantageous to shareholders as it protects managers from short-term reporting pressures and egregious opportunistic behavior that can be detrimental to firm value.

Keywords: Entrenchment; backdating; options; fraud; takeover defense; egregious opportunistic behavior

1. INTRODUCTION

The popularity of corporate practices that promote management entrenchment soared during the second half of the 1980s in response to the widespread threat of hostile corporate takeovers ([Comment & Schwert, 1995](#); [Danielson & Karpoff, 1998](#)). Recent studies document that management entrenchment influences opportunistic behaviors including (but not limited to) backdating of executive stock options, earnings management practices, and improper disclosures ([Cremers, Masconale, & Sepe, 2016](#); [Salehi, Mahmoudabadi, & Adibian, 2018](#)).

Nejat Seyhum, Professor of Finance at Michigan's Ross School of Business notes in an article published in the Michigan Press in 2016 that stock option backdating appears to have picked up again. In 2019, the *Fortune* magazine reported that backdating has resurfaced despite the prosecution of those implicated in the option backdating scandal and changes to disclosure rules for executive compensation.

Corporate practices that can entrench managers include staggered or classified boards, limitations on by-laws and charter amendments, supermajority requirements for mergers, poison pills, and golden parachutes. Staggered boards are boards with members grouped into different classes, often three, with one class of directors being eligible for reelection each year. Staggered boards restrict the power of the shareholders to appoint and remove the majority of the directors annually, which tends to weaken the supervisory power of the shareholders over the board. The weakening of the supervisory power reduces board accountability to the shareholders. Weill (2006) notes that directors depend on management for their reelection bid and sometimes form other business ties with management. The dependence of the directors on management for reelection, the cozy business relationships between directors and management, and the weakening of board accountability to shareholders negatively impact the effectiveness of the oversight that the directors exercise over the managers and may culminate in opportunistic managerial behaviors that are inimical to shareholder wealth.

The supermajority requirements for amendment of corporate by-laws, charters, and acquisitions make it difficult for shareholders to make changes to previously adopted provisions considering the number of shareholders that attend meetings (Sundaramurthy, 1996). The stipulation incapacitates shareholders from making decisions that are at variance with the interests of the managers. Accordingly, managers may be able to engage in opportunistic behaviors that are inimical to the interests of shareholders.

Poison pills give the shareholders of the target firm the right to buy additional shares of the target or acquiring firm or both firms at a deeply discounted price (Straska & Waller, 2014). Poison pills do not require shareholder approval, cannot be exercised by the acquirer, dilute the voting power of the acquiring firm, makes the transaction extremely expensive, and renders the target firm unattractive (L. Bebchuk, Cohen, & Ferrell, 2009; Straska & Waller, 2014; Sundaramurthy, 1996). These draconian stipulations entrench managers and may provide avenues for entrenched managers to engage in opportunistic behaviors. Golden parachute provides incumbent managers with attractive and extremely generous severance packages if they are dismissed or terminated when corporate control changes (L. Bebchuk et al., 2009; Straska & Waller, 2014). Golden parachute thus increases the cost of acquisition to potential acquirers. The huge cost to remove the managers discourages potential acquirers, entrench management, and may incentivize managers to act in ways that are self-serving and inimical to shareholders.

Though corporate practices that promote entrenchment remain popular, management entrenchment has aroused much controversy among researchers and practitioners. Researchers and practitioners are divided over the impact of management entrenchment on shareholders. While proponents of management

entrenchment argue that entrenchment curtails managerial opportunism and is beneficial to shareholders, opponents of management entrenchment contend that entrenchment weakens the corporate governance mechanisms of a firm, encourages opportunistic behavior by managers and is detrimental to shareholder wealth.

On the one hand, studies such as Chemmanur and Tian (2018), Meo, Lara, and Surroca (2017), and Zhao, Chen, Zhang, and Davis (2012) report evidence consistent with the view that entrenchment is advantageous to shareholders as it protects managers from short-term reporting pressures that can be detrimental to firm value. On the other hand, the findings in studies, such as Faleye (2007), L. Bebchuk et al. (2009), and L. A. Bebchuk, Cohen, and Wang (2011), suggest that management entrenchment reduces firm value and consequently the wealth of shareholders.

We examine the relation between management entrenchment and the probability of a firm being implicated in the stock option backdating scandal given that prior studies have extensively examined the impact of entrenchment on earnings management, but little attention has been given to the effect of entrenchment practices on egregious management behavior. The stock option backdating scandal is an example of corporate fraud as it is characterized by the secret backdating of stock option grant dates and the violation of securities, tax, and corporate laws.

Using the entrenchment index (E-index) as constructed by L. Bebchuk et al. (2009) as our measure of management entrenchment, we find a negative relation between management entrenchment and the probability of stock option backdating. Our finding is consistent with the line of research that documents management entrenchment as being beneficial to shareholders as it reduces pressure on management to achieve short-term reporting goals. Our finding is also consistent with the notion that management entrenchment curbs egregious opportunistic managerial behaviors and increases firm value.

Our study contributes to the literature on corporate governance and the debate on the impact of management entrenchment on agency costs and firm value. As the stock option backdating scandal is an example of corporate fraud with severe ramifications on financial reporting credibility and firm value, the results of our study should be of interest to researchers, auditors, regulators, and other stakeholders who are concerned about curbing egregious managerial behavior and protecting shareholder wealth. The remainder of the study proceeds as follows: Section 2 provides the literature review and hypothesis development. Section 3 discusses the methodology, and Section 4 reports the empirical results of the study. The conclusion follows in Section 5.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The results of prior empirical studies highlight the lack of consensus over the impact of management entrenchment on shareholders. While one strand of

research supports the view that management entrenchment is beneficial to shareholders (Bhojraj, Sengupta, & Zhang, 2017; Chemmanur, Paeglis, & Simonyan, 2011; Chemmanur & Tian, 2018; Ge & Kim, 2014; Meo et al., 2017; Zhao & Chen, 2009; Zhao, Chen, & Yao, 2009; Zhao et al., 2012), another stream of research is consistent with the view that management entrenchment is inimical to shareholders (L. Bebchuk & Cohen, 2005; L. Bebchuk et al., 2009; Chakraborty, Rzakhanov, & Sheikh, 2014; Faleye, 2007; Gompers, Ishii, & Metrick, 2003; Masulis, Wang, & Xie, 2007, 2009; Souther, 2016).

Consistent with the view that entrenchment is beneficial to shareholders, studies such as Bhojraj et al. (2017), Ge and Kim (2014), Meo et al. (2017), and Zhao et al. (2012) report evidence suggesting that management entrenchment curtails short-term pressures and opportunistic managerial behavior. In particular, Meo et al. (2017) focus on firms that meet or beat earnings benchmarks and examine the relation between management entrenchment and earnings management. They find a negative relation between management entrenchment and accrual and real earnings management, which implies that entrenched managers are under less pressure to engage in earnings management to achieve short-term reporting goals.

Studies such as Zhao et al. (2012) and Ge and Kim (2014) examine the relation between earnings management and takeover defenses that can lead to management entrenchment and report results similar to Meo et al. (2017). Specifically, Zhao et al. (2012) examine the relation between staggered boards and real earnings management. They find a negative relationship between staggered boards and real earnings management, which they attribute to less pressure to engage in opportunistic earnings management. Using a sample of firms that restated their financial statements and focusing on takeover defenses that can lead to management entrenchment, Ge and Kim (2014) find that management entrenchment mitigates the opportunistic use of real earnings management to enhance reported income. Accordingly, the results from the preceding studies support the view that entrenchment is beneficial to shareholders as it curtails managerial myopia and opportunistic earnings management that can be detrimental to firm value.

Contrary to the view that entrenchment can be beneficial to shareholders, studies such as Faleye (2007), Guo, Kruse, and Nohel (2008), L. Bebchuk et al. (2009), and L. A. Bebchuk et al. (2011) report evidence that supports the notion that management entrenchment is detrimental to firm value and shareholder wealth. Specifically, L. Bebchuk et al. (2009) examine the relation between management entrenchment and firm value and report a negative association between entrenchment and firm value, which implies that management entrenchment appears to destroy firm value. Focusing on staggered boards, which can lead to entrenchment, Faleye (2007) and L. A. Bebchuk et al. (2011) also report evidence consistent with entrenchment being associated with reductions of firm value. In addition to reporting that staggered boards are associated with lower firm valuations, Faleye (2007) reports evidence indicating that staggered boards significantly entrench management. Similar to Faleye (2007), L. A. Bebchuk et al. (2011) investigate the impact of staggered boards on firm value and find that staggered boards are associated with lower firm valuations. Based on the expectation that staggered or classified board diminishes firm value, Guo et al. (2008) use an

event study to examine the impact of declassifying a board on firm value, where declassifying a board occurs when a firm with more than one class of directors is converted to a board with only one class of directors. [Guo et al. \(2008\)](#) document that declassifying a board increases firm value, which is consistent with management entrenchment reducing firm value.

The results from prior studies appear to be contradictory as some studies report that management entrenchment is associated with reduced firm value while other studies report that management entrenchment is associated with lower earnings management, which can be favorable to firm value. A possible reason for the contradictory findings is that equity investors may be discounting the valuation of firms with entrenched managers as they perceive entrenched managers as being less likely to invest in risky projects that boost firm value. Consistent with this view, [Hwang and Lee \(2011\)](#) document reduced variability in firm valuation as well as a valuation discount for firms with entrenched managers which implies that investors perceive such firms as being less likely to pursue risky projects that could enhance firm value.

Given that the reported negative association between management entrenchment and firm value could also imply that management entrenchment weakens corporate governance mechanisms and enables managers to engage in opportunistic behavior that is detrimental to firm value, we examine the relation between management entrenchment and egregious opportunistic behavior. We focus on the probability of a firm being implicated in the stock option backdating scandal as the backdating of stock options is an egregious managerial opportunistic behavior. Extant literature documents that backdating is employed by managers that (a) are highly unethical ([Adam & Schwartz, 2009](#)); (b) have substantial managerial power ([Jia, 2014](#); [O'Connor, Priem, Coombs, & Giley, 2006](#); [Rezaee, 2007](#)); and (c) are selfish, undisciplined, and lack integrity ([Jia, 2014](#)).

Secret backdating increases the personal wealth of managers as the options are granted at a price lower than the prevailing stock price (in-the-money). The personal wealth of the managers is also increased as the managers disguise non-performance-based compensation (in-the-money) as performance-based compensation (at-the-money options) to reduce their individual tax liability. Secret backdating also overstates the profits of the firm as the managers fail to recognize as compensation expense, the amount by which the market price of the stock exceeds the exercise price on the grant date ([Balsam, Bartov, & Yin, 2006](#); [Fried, 2008](#)).

The disguising of non-performance-based compensation as performance-based compensation culminates in the lowering of Federal Insurance Contribution Act (FICA) taxes withheld and the attendant reduction of the revenue generated by the Internal Revenue Service (IRS). Prior to the 2017 Tax Cuts and Jobs Act, Section 162(m) of the IRS code, non-performance-based compensation was subject to a deduction limit of one million dollars, whereas no deduction limit was placed on performance-based compensation as performance-based compensation was aimed at incentivizing managers to make decisions that will ultimately enhance shareholder wealth. Secret backdating of executive stock options is a violation of the duty of care that the managers are required to exercise toward the shareholders of the firm ([Fried, 2008](#)).

The fraudulent backdating of options can be linked to the fraud triangle and its three components, which are pressure, opportunity, and rationalization. Financial pressure on managers, such as pressure to preserve or enhance personal status and personal income, can motivate the backdating of options. As to opportunity, backdating of options is more likely to occur when there is greater opportunity for fraud such as ineffective oversight of the board and weak communication or enforcement of code of ethics. Finally, managers may rationalize corporate fraud such as option backdating by alluding to the onerous responsibilities and financial benchmarks that they have to achieve (Soltani, 2014).

The discovery of secret backdating typically results in a restatement of the financial statements, a sharp drop in firm value, and substantial losses in investor capital. Consequently, shareholders filed securities class action lawsuits, and the Securities and Exchange Commission (SEC) initiated enforcement actions against directors and management of firms implicated in the option backdating scandal (Fried, 2008). The literature documents that managers engage in egregious and opportunistic behavior such as the backdating of executive stock options when corporate governance is ineffective (Collins, Gong, & Li, 2009; Gul, Chen, & Tsui, 2003; Hossain, Mitra, Rezaee, & Sarath, 2011).

From the preceding discussions, management entrenchment can weaken (a) the threat of removal of the managers, (b) the threat of corporate takeover, and (c) the monitoring effectiveness of the board and engender managerial actions that are self-serving and detrimental to shareholder wealth. Conversely, management entrenchment may curtail the backdating of stock options as it can strengthen managerial job security and curb managerial myopia. Accordingly, we employ a non-directional hypothesis, and we state our hypothesis in its null form as follows:

H1. Management entrenchment is not associated with the backdating of executive stock options.

3. METHODOLOGY

3.1. Sample and Data Collection

Similar to prior studies such as Ertimur, Ferri, and Maber (2012), Rezaee (2009), and Rezaee, Langstraat, and Malloy (2008), data on firms implicated in the option backdating scandal were obtained from the Yellow Card Trends Alert of Glass Lewis & Co. (<https://www.glasslewis.com/>). The Yellow Card Trends Alert reports 271 firms that were implicated in the backdating scandal by the SEC, Department of Justice (DOJ), or firm-level internal investigation.

We obtained firm financial data from the Compustat database and E-index data from L. Bebchuk et al. (2009). Appendix 2 describes the construction of E-index by L. Bebchuk et al. (2009). We excluded firms without E-index and Compustat data. We also excluded firms in the financial (Standard Industrial Classification (SIC) 48 and 49) and utility sectors (SIC 60–69) because these companies differ markedly in their underlying business, and they are subjected to other regulations.

We then matched the backdating firms by year, industry (using two-digit SIC code), and firm size following [Barber and Lyon \(1996\)](#) and [Kothari, Leone, and Wasley \(2005\)](#). We classified the firms that were implicated for backdating stock options as the test sample and the firms that were not implicated in the backdating scandal as the control sample. Excluding firms with missing data resulted in a final sample of 290 firm-year observations. Finally, we winsorized our data for all variables at the top and bottom 1% to reduce the impact of outliers.

3.2. Model

We examined the relation between management entrenchment and the probability of backdating executive stock options. Our proxy for management entrenchment is the E-index as constructed by [L. Bebchuk et al. \(2009\)](#). The first four entrenchment provisions, which are staggered boards, limits to shareholder amendments of the by-laws, supermajority requirements for mergers, and supermajority requirements for charter amendments, are designed to limit the voting power of shareholders. The last two entrenchment provisions, poison pills, and golden parachute are designed to discourage hostile takeover bids. We used the backdating of executive stock options as a proxy for egregious managerial opportunistic behavior. We use a logistic regression model with the probability of backdating as the dependent variable and the following as independent variables: E-index, BIG 4 auditor, return on assets, free cash flow, stock return volatility, leverage, firm growth, and firm size. Our logistic regression model is as follows:

$$\text{Backdate} = f(\text{E-index}, \text{AUD}, \text{ROABD}, \text{FCF}, \text{STK_VOL}, \text{LEV}, \text{MBV}, \text{SIZE})$$

Appendix 1 provides the definitions of variables used in the logistic regression model. We used the binary variable Backdate to denote whether a firm was implicated in the option backdating scandal. A value of 1 indicates that the firm was implicated in the backdating scandal, and a value of 0 indicates that the firm was not implicated. The E-index variable constructed by [L. Bebchuk et al. \(2009\)](#) measures the level of managerial power. Firms with stronger managerial power or weaker shareholder rights have a higher number of entrenchment provisions, while firms with stronger shareholder rights or firms with weaker managerial power have a lower E-index. We assign zero to firms with no entrenchment provision. We also include industry and year fixed effects to capture the influence of aggregate trends.

Other control variables include AUD (BIG 4 auditor), ROABD (return on assets), FCF (free cash flow), STK_VOL (stock return volatility), LEV (leverage), MBV (growth), and SIZE (firm size). The variable AUD is a binary variable that denotes whether a firm is audited by one of the BIG 4 public accounting firms. The value 1 is used to indicate the presence of a BIG 4 auditor and 0, otherwise. [Houge, Ahmed, and Zijl \(2017\)](#) find that high-quality auditors are associated with lower earnings management practices. We contend that a BIG 4 auditor is expected to provide a higher quality audit, which is likely to mitigate opportunistic managerial behaviors such as the backdating of stock options. We thus expect a negative relation between AUD and Backdate.

ROABD is used to denote the return on assets, an indicator of a firm's operating performance. We operationalized return on assets as operating income plus depreciation (OIBDP) divided by total assets (AT). Poor performance could engender managers to engage in egregious opportunistic behavior such as backdating of executive stock options (Gao, Harford, & Li, 2012; Lobo, Manchiraju, & Sridharan, 2018). Therefore, we expect a negative relation between ROABD and Backdate.

FCF is used to denote free cash flow. Free cash flow is the amount of cash remaining after all projects with positive net present values have been funded (Jensen, 1986). We computed free cash flow as the difference between operating cash flow and capital expenditures, scaled by AT. Jensen (1986) suggests that unethical and self-serving managers prefer to hold excessive cash because cash can easily be misappropriated. We, therefore, expect a positive relation between the FCF and Backdate.

STK_VOL denotes stock return volatility. We computed stock return volatility as the standard deviation of daily stock returns. Francis, Philbrick, and Schipper (1994) document that substantial stock price declines could engender shareholder class action lawsuits, which can curtail opportunistic managerial behaviors. However, McAnally, Srivastava, and Weaver (2008) report that the desire of unethical managers to receive stock option grants at a lower strike price incentivizes opportunistic managerial behavior such as deliberately reporting losses. Accordingly, we do not make any prediction regarding the direction of the relation between STK_VOL and Backdate.

LEV is used to denote financial risk or leverage. We computed LEV as the total long-term debt (DLTT) plus current liabilities (DLC) divided by AT. While studies such as Beatty and Weber (2003), Dichev and Skinner (2002), and Sweeney (1994) document that firms engage in opportunistic manipulation of earnings to avoid tighter debt covenants, Jelinek (2007) documents a negative relation between leverage and the propensity to manage earnings. Therefore, we do not predict the direction of the relationship between Backdate and LEV.

MBV denotes firm growth, computed by dividing the market value of equity ($CSHO \times PRCC_F$) by the book value of equity (CEQ). Skinner and Sloan (2002) document that the market penalizes high-growth firms that are unable to meet projected analysts' forecasts. Veld and Wu (2014) find that fast-growing firms are more likely to backdate executive stock options to attract and retain high caliber top management talent. Thus, we expect a positive relation between MBV and Backdate.

SIZE represents the size of the firm, which we operationalize as the natural log of AT. Chow and Wong-Boren (1987) and Eng and Mak (2003) find a positive relation between firm size and information disclosure. Collins et al. (2009) find a positive relationship between firm size and managerial monitoring. Considering that effective managerial monitoring is related to the size of a firm, and effective monitoring results in enhanced information disclosure or reduced information asymmetry, we expect a negative relation between SIZE and Backdate.