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The determinants of IPO-related shareholder litigation: The role of CEO equity incentives and corporate governance

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A B S T R A C T

We examine how compensation and corporate governance mechanisms affect the occurrence of securities fraud and related shareholder litigation for initial public offering (IPO) firms. While prior research has focused on seasoned firms, we examine how CEO incentives and corporate governance in IPOs affect the incidence of IPO-related shareholder litigation. We find that the likelihood of securities fraud allegations increases with pre-IPO CEO equity incentives, suggesting a “dark side” to executive equity incentives. The risk of being sued is higher for firms whose boards are dominated by insiders, whose CEOs are older, have shorter tenure, or who founded the firm.

1. Introduction

The principal-agent theory, proposed by Jensen and Meckling (1976), suggests that stock-based executive compensation and equity holdings help reduce agency conflicts by aligning the interests of corporate managers with those of a firm's shareholders. Yet, despite its allure and widespread use,

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executive stock-based compensation has come under increased scrutiny since the early 2000s by being tied to numerous corporate scandals that involved earnings manipulation and various other violations of the securities laws. In many of these cases, managers hyped up their firm's share price through accounting manipulations as well as misrepresentations and omissions of adverse developments, only to exercise their options and sell their stock holdings at elevated levels before revealing their firm's true financial position.

Our study attempts to contrast the expected positive effects of equity-based incentives with their disadvantages. Studies that explored the unintended consequences of equity-based incentives have examined earnings management (Ke, 2001; Gao and Shrieves, 2002; Cheng and Warfield, 2005; Bergstresser and Philippon, 2006), accounting re-statements (Burns and Kedia, 2006; Efendi et al., 2007; Harris and Bromiley, 2007; Baber et al., 2009; Armstronget al., 2010, 2013), accounting fraud (Erickson et al., 2006; Johnson et al., 2009), and class action lawsuits (Denis et al., 2006; Peng and Roell, 2008a; Jayaraman and Milbourn, 2009; Wang et al., 2010; Jayaraman and Milbourn, 2014). Almost all prior studies in this area focus on seasoned firms, and the few initial public offering (IPO) related studies that exist use post-IPO rather than pre-IPO data in their analyses. We aim to close this gap in the literature by providing the first study that examines the direct relation between the incidence of IPO-related class action lawsuits and CEO compensation that is awarded prior to the IPO. Specifically, we focus on equity incentives from pre-IPO options (defined as options that are issued prior to an IPO and whose exercise price is not directly linked to the offer price), and from pre-IPO equity ownership.

Pukthuanthong et al. (2007) suggest that IPO firms provide an ideal setting for studying the link between executive compensation and firm performance. In the same vein, we believe that IPO firms present us with a particularly fertile laboratory for studying how CEO incentives affect the likelihood that firms are sued for securities fraud in connection with their IPO. First, IPO firms differ significantly from seasoned firms. As Bhabra and Pettway (2003, p 370) note: “Information contained in a prospectus is often the first window to a potential investor about the firm's past and its projected future performance.” Therefore, the level of information asymmetry tends to be higher for IPO firms, which, in turn, may give CEO a better opportunity to deceive the market. Second, founders or professional managers who decide to take their firm public are likely to confront a variety of new pressures they have not experienced before. On the one hand, they have to fulfill the high expectations of underwriters, industry analysts, venture capitalists, and outsiders. On the other hand, they are likely to experience a substantial shift in their personal wealth as their compensation moves away from being salary- and bonus-based to being closely tied to the firm's share price. These factors may drive some top executives to portray their firms in an overly positive light and engage in manipulative or fraudulent activities during the IPO process in order to meet outside expectations or maximize their own wealth. Third, studying IPO-related class action lawsuits is particularly appealing because these lawsuits tend to be defined more narrowly (typically alleging misrepresentations or omissions in a firm's IPO prospectus) than lawsuits against seasoned firms. Lastly, from the perspective of IPO investors, pursuing an IPO firm in court tends to be less costly than pursuing a seasoned firm as lawsuits brought under Section 11 of the Securities Act of 1933 do not require investors to prove that they relied on false or misleading information or omissions in the offering statement.

Our study aims to answer the question of whether CEOs with higher equity incentives are more likely to commit fraud and thereby cause their firms to be sued in a class action lawsuit. We analyze a sample of 81 IPO firms in the United States that went public between 1997 and 2007 and subsequently became the target of a shareholder class action lawsuit under Section 11 of the Securities Act of 1933, as well as an industry-size-year matched control sample of 81 non-sued U.S. IPO firms. We assembled a unique, hand-collected data set that contains detailed information on the lawsuit characteristics, executive compensation and equity ownership structure, and other corporate governance characteristics of these 162 firms. Our findings support our main hypothesis: firms in which CEOs have higher equity incentives prior to an IPO are more likely to become the target of a securities class action lawsuit after the IPO. This result is robust when we apply propensity score matching and consider abnormal equity incentives (i.e., equity incentives beyond the desired level). However, the positive association only prevails in high-tech firms and is insignificant for non-high-tech firms. When classifying lawsuits based on their alleged fraud allegations (i.e., accounting-related cases vs. non-accounting cases), our results are similar in both subsamples. In addition, we find evidence that IPO firms whose boards are dominated by insiders face a higher litigation risk. Consistent with