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Suspect CEOs, unethical culture, and corporate misbehavior ☆

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ABSTRACT

We show that firms with Chief Executive Officers (CEOs) who personally benefit from options backdating are more likely to engage in other corporate misbehaviors, suggestive of an unethical corporate culture. These firms are more likely to commit financial fraud to overstate earnings. They acquire more private companies, which could perpetuate their frauds, and their acquisitions are met with lower market responses. These misbehaviors are concentrated in firms with externally hired suspect CEOs, consistent with outside CEOs having greater discretion to shape firm culture. The costs of these misbehaviors are reflected in larger stock price declines during a market correction and increased CEO replacement.

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"*Finally, what we have learned from stock options backdating — and from every other scandal in the financial markets in recent years — is that character matters. Corporate character matters — and employees take their cues from the top. In our experience, the character of the CEO and other top officers is generally reflected in the character of the entire company. If a CEO is known for his integrity, integrity becomes the corporate norm. If, on the other hand, a company's top executives are more interested in personal enrichment at the expense of the shareholders, our backdating investigations demonstrate yet again that other employees will follow suit.*"

–Linda Chatman Thomsen, Director, Division of Enforcement, Securities and Exchange Commission

1. Introduction

Scandals at firms such as Enron, WorldCom, Tyco, and HealthSouth exposed numerous corporate executives who were complicit in perpetuating fraudulent activities that ultimately resulted in billions of dollars in shareholder losses. As a result, the topic of business ethics is receiving a dramatic increase in attention from the U.S. legislature, regulatory bodies such as the Securities and Exchange Commission (SEC), the popular press, and business schools around the world. Of particular importance in the current dialog is an understanding of (and potential means to

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mitigate) the forces that drive firms to mislead investors and cause the misallocation and destruction of scarce societal resources.

Anecdotal evidence suggests that fraudulent firms are often characterized by an unethical culture that permeates a nexus of employees, whose cooperation is necessary to perpetrate extensive corporate malfeasance (Langevoort, 2006). For instance, approximately 30 employees at Health-South and Peregrine Systems were convicted or pled guilty to charges related to financial statement fraud. But where does an unethical culture originate? The above quotation by Linda Thomsen, a former head of the Division of Enforcement at the SEC, represents a seasoned insiders' view that an unethical culture emanates from the actions and attitudes of those at the very top level of corporate leadership, in particular, the CEO. Her top-down perspective is echoed in the influential academic "upper echelons theory" of corporate behavior (Chatterjee and Hambrick, 2007; Hambrick, 2007). While numerous prior studies provide support for the upper echelons theory by establishing a relationship between certain executive characteristics and the economic outcomes of the firms that they manage (e.g., Bertrand and Schoar, 2003),[1] there is a clear deficiency of empirical work focused on the ethical dimension of a corporate culture.

The dearth of empirical work in this area could stem from the fact that the ethical values of corporate executives are difficult to empirically quantify. In this paper, we attempt to test whether executives with questionable ethics lead their firms to engage in broader corporate malfeasance. We propose a novel way to identify an unethical pattern of behavior, based on systematic participation in options backdating. In Section 2 we review employee stock option backdating practices at many U.S. firms in the 1990s and early 2000s. We submit that many of these cases are reasonably characterized as stealth activities undertaken by executives for their own personal gain and at an economic cost to other parties. However, we also recognize that there are disparate views regarding the ethics of backdating in general, and acknowledge that specific actions in some individual cases were not obviously inappropriate. On balance, we offer that it is reasonable to test our hypotheses using systematic participation in options backdating to identify executives with questionable ethics; although we concede that one could interpret our results with caution if they disagree with this characterization.

In our first set of analyses, we find that firms with CEOs who benefit directly from options backdating (hereafter 'suspect' firms) are also more likely to engage in fraud. Additional analyses provide evidence that suspect firms overstate their profitability and engage in suboptimal investment strategies. Furthermore, these misbehaviors increase following a suspect CEOs arrival and are concentrated in firms that hire their suspect CEOs from the outside. Finally, we explore some of the consequences of these behavior patterns and find that suspect CEOs are more likely to be fired and their firms are more likely to experience large losses during a market correction.

Overall, our results are consistent with the upper echelons theory in understanding how an unethical culture among corporate executives prevails and contribute to a broader literature on organizational culture (Kreps, 1990; Hodgson, 1996). Our findings support claims in the managerial discretion literature (Hambrick and Finkelstein, 1987) that outside CEOs enjoy greater decision-making discretion, and are also related to a literature that investigates the economic consequences of corporate fraud (e.g., Karpoff and Lott, 1993; Alexander, 1999; Murphy, Shrieves, and Tibbs, 2009). For example, Bernile and Jarrell (2009) show that the negative market reaction associated with firms implicated in backdating is much larger than the direct costs of the backdating activity. Our results provide support for their proposition that this response likely reflects the market's expectations about other suspect activities also present at backdating firms.

We use a data-driven approach to identify systematic options backdating. To be classified as a systematic backdater, at least 30% of an individuals' options activity (grants and/or exercises) must be characterized as "likely backdated." Using data from 1992 to 2009, we identify 249 backdating CEOs and augment this list with 12 additional CEOs who did not meet our identification criteria, but who are specifically named in an enforcement action or backdating settlement. We match our sample of suspect firms to a corresponding sample of non-suspect firms based on industry and firm size to control for other determinants of corporate malfeasance in our empirical analyses.

Univariate and multivariate analyses indicate a strong association between suspect firms and other forms of corporate misbehavior. We find that 8.82% of our suspect firms are implicated in a financial fraud compared to 2.94% for control firms. Given that instances of fraud are likely to engender class-action lawsuits by shareholders, it is not surprising that we also find the incidence of lawsuits is significantly greater for our sample of suspect firms when compared to their control group (26.3% versus 13.9%). Tests of earnings manipulation provide corroborating evidence of misbehavior at suspect firms. Firms with backdating CEOs are 14.55% more likely than control firms to narrowly meet or beat analysts' quarterly earnings forecasts, a tendency previous researchers point to as evidence of accounting manipulations aimed at bolstering stock prices (Hayn, 1995; Degeorge et al., 1999). Consistent with this interpretation, we find that suspect firms use significantly more positive discretionary accruals in the quarters when they narrowly attain these thresholds. These results hold in a multivariate setting that controls for firm characteristics, firm governance, prior financial performance, auditor identity, and the ownership and option compensation of the CEO.

We extend our empirical analyses by investigating the investment activities of suspect firms. Suspect firms make significantly more acquisitions and their acquisition announcements are met with a lower market response. Excessive acquisition activity could be motivated by either selfish empire building (Jensen, 1986; Lang, Stulz, and Walkling, 1991; Morck, Shleifer, and Vishny, 1990) or to

[1] Prior academic research focuses on executive characteristics such as overconfidence (Malmendier and Tate, 2008), political affiliation (Hutton, Jiang, and Kumar, forthcoming), gender (Huang and Kisgen, 2013), narcissism (Chatterjee and Hambrick, 2007), personal risk taking (Cain and McKeon, forthcoming), and personal tax aggressiveness (Chyz, 2013).

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