“Weak” Governance May Be Optimal Governance: 
A Discussion of Corporate Governance and Backdating of 
Executive Stock Options

Robert M. Bushman
Kenan-Flagler Business School
University of North Carolina-Chapel Hill
bushman@unc.edu

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In this discussion, I provide some big picture thoughts on the Collins, Gong and Li (2009) paper (CGL hereafter) entitled: Corporate Governance and Backdating of Executive Stock Options. CGL utilize an estimation algorithm to generate a large sample of potential incidences of grant-level backdating behavior. The conceptual premise of the paper is that the backdating of CEO stock option grants is a direct consequence of “weak” corporate governance structures. The authors make directional predictions about the relation between firms’ individual governance structures and the probability that stock option backdating occurs. Each governance structure for a firm is represented by a numerical metric where higher values are interpreted as weaker governance. For example, governance is posited to get weaker as the proportion of inside or gray directors increases. The authors then predict the probability of backdating to be an increasing function of the metric representing each individual governance structure.

CGL adds to the stream of papers that empirically examine the backdating issue (e.g., Heron and Lie (2007), Bebchuk, Grinstein and Peyer (2007), and Bizjak et al., (2006)). In some sense, CGL is the culmination of this research line. CGL replicates a number of results spread across the extant literature, and add some twists and turns of their own. The authors do a nice job in the paper of isolating their unique contributions, so I need not repeat any of that here. Overall, this is a very careful piece of empirical research, and I have no intention of nit-picking the empirical analysis. Instead, I offer a critique of the paper that is pertinent to the entire literature on backdating and to empirical corporate governance research in general. In particular, I consider fundamental problems in interpreting statistical associations between corporate behavior and measures of individual corporate governance structures.

A large body of corporate governance research, including CGL, regress measures of corporate behavior on metrics of corporate governance attributes. But this design raises a series
of deep, fundamental questions. Where do governance structures come from? If governance structures arise endogenously because economic players choose them in response to the circumstances they face, how do we interpret empirical analyses that regress corporate behavior (e.g., backdating) on measures of observed governance? If we observe what appears to be a poor governance structure, why was that structure chosen? While it is possible that the structure was chosen by mistake or via insidious opportunism, it may also represent an optimal, but imperfect, solution to the particular circumstances of the firm. After all, firms face intense survival pressures from competition in factor, capital, and product markets, and blatant errors in organizational design would be unlikely to persist in the long run. A key point is that optimal solutions to organizational design problems in the presence of information asymmetry do not necessarily eliminate all bad behavior or maximize surplus. There are trade-offs, and eliminating all bad behavior may be so costly as to make this objective undesirable. A large literature on agency problems posits governance structures as second best solutions to organizational optimization problems constrained by the existence of information asymmetries (e.g., Jensen and Meckling (1976), Holmstrom (1979), Hermalin and Weisbach (1998, 2003)).

Now, CGL is well aware of the endogeneity issue, and actually devote a separate subsection to discussing the issue. But CGL, along with many others in the literature, focus the discussion on the econometrics of endogeneity, rather than on the economics of governance in a constrained world subject to second best outcomes. CGL correctly notes that one potential econometric solutions to endogeneity is two-stage least squares that rely on instrumental variables. But, it is well known that corporate governance is a complex phenomenon, making it difficult, if not impossible, to find adequate instrumental variables to deal with endogeneity. They conclude their discussion by pointing to aspects of their setting that makes it unlikely that
correlated omitted variables are driving their results. Rather than taking on the always elusive issue of correlated omitted variables, I instead want to evaluate CGL’s results with respect to board attributes in the context of second best solutions.

From CGL, Table 4, we see that the probability of backdating is increasing in the percentage of inside directors on the board, the percentage of outside board members who are appointed after the CEO took office, and if the CEO is also chairman of the board. CGL thus conclude that weaker corporate governance structures that give rise to greater managerial power over the boards, lead to a higher incidence of backdating executive stock options. While they do not state policy recommendations based on their results, the unstated implication is that “CEO power” is a bad thing for corporations necessitating some sort of unspecified changes in governance systems to counterbalance this power with stronger governance. At a minimum, without further qualification of their position, this paper directly serves the position of those who call for a fundamental shift in the balance of power between boards and shareholders in publicly traded U.S. corporations (see e.g., Bebchuk (2007), Stout (2007), and Anabtawi (2006)). Is significant CEO power a suboptimal outcome and inherently bad? Where does CEO power come from?

In addressing these questions, I begin by examining more closely the correlation structure between governance metrics in CGL’s Table 3. In particular, it is interesting to note that CEO tenure is highly correlated with a number of board characteristics. CEO tenure has a Pearson correlation of .67 with the percentage of outside board members who are appointed after the CEO took office (CEOHIREDIR), .32 with the CEO also being chairman of the board (CEOCHR), .30 with the percentage of shares owned by the CEO (CEOOWN), and .14 with the percentage of inside directors on the board (INSIDEDIR). The connection of this wide range of
governance metrics with CEO tenure is important because CEO tenure is unambiguously endogenous. It is very unlikely that poorly performing CEOs will survive over the long haul. In fact, this pattern of correlation between CEO tenure and other aspects of governance is consistent with a number of economic models that focus on optimal second best solutions to governance design (see Adams, Hermalin and Weisbach (2008) for a recent synthesis of the literature). To illustrate my main point, I consider Hermalin and Weisbach (1998) which focuses on how the assessment of ability relates to the power of the CEO.

In the model of Hermalin and Weisbach (1998), the board updates its beliefs about an incumbent CEO’s ability based on observed performance. Given their updated beliefs, the board may choose to dismiss the incumbent and hire a replacement CEO, or it may bargain with the incumbent CEO with regard to changes in board composition and future salary. Following this round of decisions, the board next chooses whether to obtain a costly signal about CEO ability (either of the incumbent if retained or of the replacement CEO). Based on this signal, if obtained, the board again decides whether to keep or replace the CEO. Finally, terminal period profits are realized, where the expected value of profits is a positive function of the sitting CEO’s ability.

The key point for my discussion of CGL is that the board’s inclination to obtain an additional signal is a function of its independence from the CEO, which in turn depends on the outcome of the bargaining game between the board and the incumbent CEO if he is retained. Because the additional signal can only increase the risk of being dismissed and the CEO enjoys a non-contractible control benefit, the CEO prefers a less independent board with less inclination to acquire an additional signal. When the CEO has bargaining power—specifically when he has demonstrated by performing well that he is a rare commodity relative to the pool of replacement CEOs—the board’s independence declines. Intuitively, a CEO who is assessed to possess above
average talent bargains for more compensation and a lower degree of board independence (as he prefers remaining as CEO to being fired). So a high performing CEO ultimately ends up facing a less independent board. But this outcome does not represent “weak governance”. It is the optimal, second best solution!

Consistent with the Hermalin and Weisbach (1998) framework, Baker and Gompers (2003) and Boone et al. (2007) find evidence consistent with successful CEOs being able to bargain for less independent boards. Boone et al. (2007) find that measures of CEO bargaining power, tenure and CEOs’ shareholdings, are negatively correlated with board independence. Measures indicative of the CEO having relatively less bargaining power, including outside director ownership, venture capital reputation, and the reputation of the firm’s investment banker at the time of its IPO, are all positively correlated with board independence. Similarly, Baker and Gompers find that measures of CEO’s bargaining power, including the CEO’s Shapley value and reputation of the firm’s venture capitalists, have the predicted signs with respect to the percentage of inside directors on the board.

As I described above, this same basic pattern is observed in CGL’s data. So what are we to make of the reported associations between backdating and governance structures, particularly board attributes? First, I believe that the associations documented by CGL are indeed real, and they are in fact consistent with evidence documented elsewhere in the backdating literature. Secondly, it is very difficult to sustain an argument that the option backdating epidemic reflects good corporate behavior. While there is nothing per se wrong with granting in-the-money stock options to CEOs, backdating involved violations of existing accounting rules and a lack of disclosure to shareholders about the policy. However, in a world of second best solutions to organizational design problems, observations of bad behavior are not definitive proof that the
governance system is broken. Powerful CEOs generally get powerful as a result of past performance successes which result in high assessments of CEO talent levels. And while powerful CEOs may use their power to improve their own well-being, any costs associated with this behavior may be swamped by the benefits of having a talented CEO at the helm of the company.

A fundamental problem I have with CGL and other papers in the literature is the pejorative use of terminology like “weak governance” to describe individual governance structures, when the empirical design of the paper is not ex ante powerful enough to convincingly distinguish weak governance from optimal second best solutions. Perfunctory discussions of the econometrics of endogeneity do not provide free license to dismiss the deep issues of endogeneity and simplistically interpret observed governance outcomes as weak. In so doing, these papers convey the impression that governance is broken, and that by changing individual governance structures from “weak” to “strong” the world will be a better place. It is also plausible that changing a few governance levers without rethinking the overall nature of the organizational design may actually makes things worse (e.g., Lipsey and Lancaster (1956)). Whether they say it directly or not, CGL implicitly delivers the message that CEO power is the root of the broken governance problem. But this begs the question of how CEOs become powerful to begin with, and what this implies about the organizational structure of the firm in a second best world. After all, what is the alternative to powerful CEOs? Are weak CEOs preferable? How weak should they be? Is this really the path U.S. corporate governance should pursue?
References


