

# **Executive pay, earnings manipulation and shareholder litigation**

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## **Abstract**

The paper examines the relationship between executive compensation and shareholder class action litigation. We find that incentive pay in the form of options significantly increases the probability of a subsequent shareholder class action lawsuit making allegations about the firm's activities during the following fiscal year, controlling for a wide range of firm characteristics, such as industry classification, volatility and size. In contrast, base pay levels and executive share ownership do not have a significant impact on lawsuit incidence.

We further examine whether earnings manipulation, as measured by estimated discretionary current accruals, is an important channel for this phenomenon. Incentive pay does have a significant impact on our measure of earnings manipulation, which in turn significantly affects the probability of litigation. However, this mechanism does not account for the full impact of compensation on litigation, suggesting that other channels may also be important. Conversely, we also document that some litigation is associated with earnings manipulation activity that does not seem to be directly related to managers' compensation contracts.

Our results suggest that the fast-vesting options that represent a substantial component of current executive pay may give managers perverse incentives to self-deal by, for example, manipulating earnings, and that such misbehavior ultimately triggers shareholder class action lawsuits. A natural conclusion is that incentive compensation contracts should focus more on long-term incentives, and that the optimal design of such contracts is an important direction for economic research. In addition, our results are relevant to the current policy debate on how to make private securities litigation a more effective deterrence mechanism. We find that such litigation is triggered by both managerial self-dealing and the underlying incentives for it, a necessary condition for an effective disciplinary role.

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