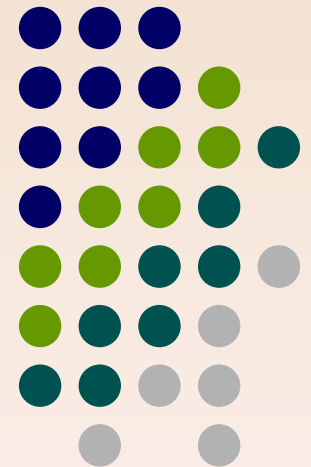


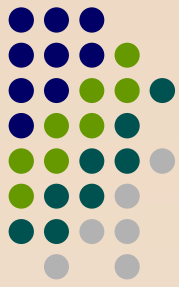
Lucky Directors

Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer

Yale School of Management
February 21, 2007

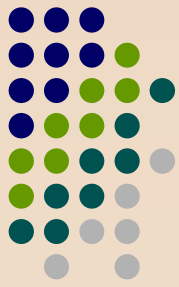


The Backdating Scandals



- More than 150 companies have come under scrutiny since the media began focusing on the subject in the spring of 2006
- The SEC and a small army of private law firms hired by companies are investigating past grant practices in many other companies.
- Dozens of executives have been forced to resign, and dozens of companies announced that they will have to restate their past financial statements.
- Hearings in the Senate Banking and Finance committees held hearings on the subject.

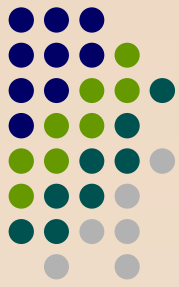
Concerns about the Role of Outside Directors



“Boards of directors were either asleep at the switch, or, in some cases, willing accomplices themselves.”

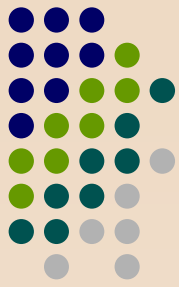
-- Chairman Grassley, Senate Finance committee,
Opening statement in hearing on backdating

Concerns about outside directors' role focused on directors "failure" to prevent the backdating of executives' options – it was assumed that directors' option grants have not themselves been the product of opportunistic timing



This Paper

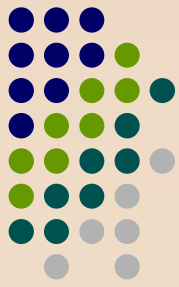
- Shows that opportunistic timing has substantially affected not only executives' option grants but also directors' option grants.
- Identify characteristics of firms, directors, and circumstances that are associated with such opportunistic timing.
- Outside directors play a key role in our corporate governance system (e.g., Milstein-MacAvoy (1998), Jensen (1993)) -- Our results are relevant for understanding both the imperfections of outside directors and the arrangements that can be expected to make them perform best.



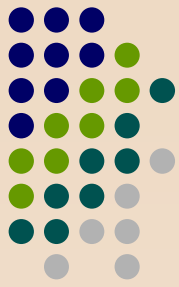
Prior Literature

- Substantial work on the opportunistic timing of executives' grants
[e.g., Yermack (1997); Aboody and Kaszink (2000); Chauvin and Shenoy (2001); Lie (2005); Heron and Lie (2006); Narayanan and Seyhun (2006); Bebchuk, Grinstein, and Peyer (2006)]
- Our work is the first to provide evidence about the opportunistic timing of directors' grants.

Data



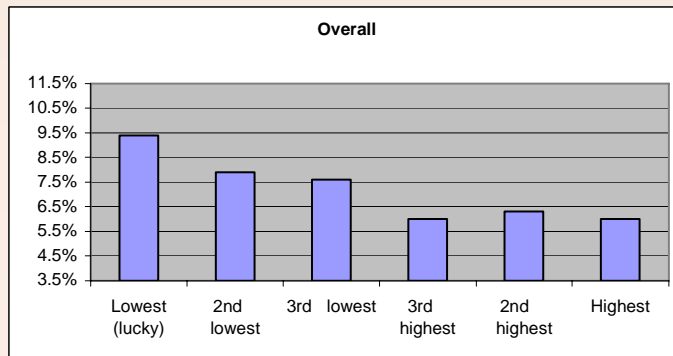
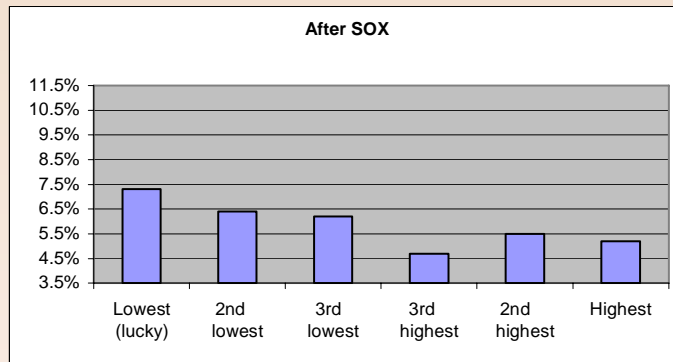
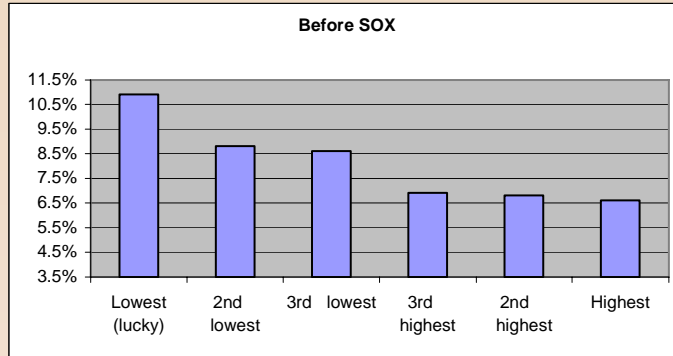
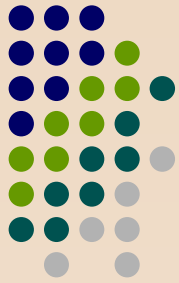
- Thomson Financial Insider Trading Database.
- 1/1996-12/2005
- 92,253 grants to 32,139 different directors.
- Unit of observation: GRANT EVENT for a firm = day with at least one grant to an outside director.
- 28,764 director grant events in 6,577 firms.



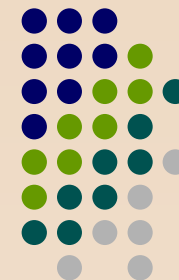
DISTRIBUTION OF LUCK FOR OUTSIDE DIRECTOR GRANTS

Panel A: All Grant Events										
		Percent of Grant Events At:								
	Total number of grant events	Lowest (Lucky)	2 nd lowest	3 rd Lowest	3 rd highest	2 nd highest	Highest	Below median	Above median	Difference
Before SOX	17512	10.2%	8.4%	8.3%	6.9%	6.7%	6.4%	49.3%	42.3%	7.0%
After SOX	11252	7.1%	6.3%	6.2%	4.8%	5.4%	5.1%	50.2%	44.7%	5.4%
Overall	28764	9.0%	7.6%	7.5%	6.1%	6.2%	5.9%	49.6%	43.2%	6.4%
Panel B: Grant Event Date Known to Coincide With Annual Meeting Date (+/- 1 Day)										
Before SOX	1803	4.6%	5.0%	5.9%	6.8%	5.4%	4.7%	44.7%	49.8%	-5.0%
After SOX	752	4.0%	4.4%	6.8%	6.3%	4.5%	3.7%	49.3%	46.5%	2.8%
Overall	2555	4.4%	4.9%	6.1%	6.6%	5.2%	4.4%	46.1%	48.8%	-2.7%
Panel C: Sample Excludes Grant Events Known to Coincide With Annual Meeting Date (+/- 1 Day)										
Before SOX	15709	10.9%	8.8%	8.6%	6.9%	6.8%	6.6%	49.8%	41.4%	8.4%
After SOX	10500	7.3%	6.4%	6.2%	4.7%	5.5%	5.2%	50.2%	44.6%	5.6%
Overall	26209	9.4%	7.9%	7.6%	6.0%	6.3%	6.0%	50.0%	42.7%	7.3%

MONTHLY PRICE RANKS OF GRANT EVENTS

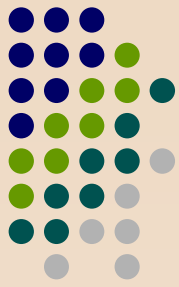


PRICE RANK AND THE LIKELIHOOD OF SELECTION AS A GRANT DATE

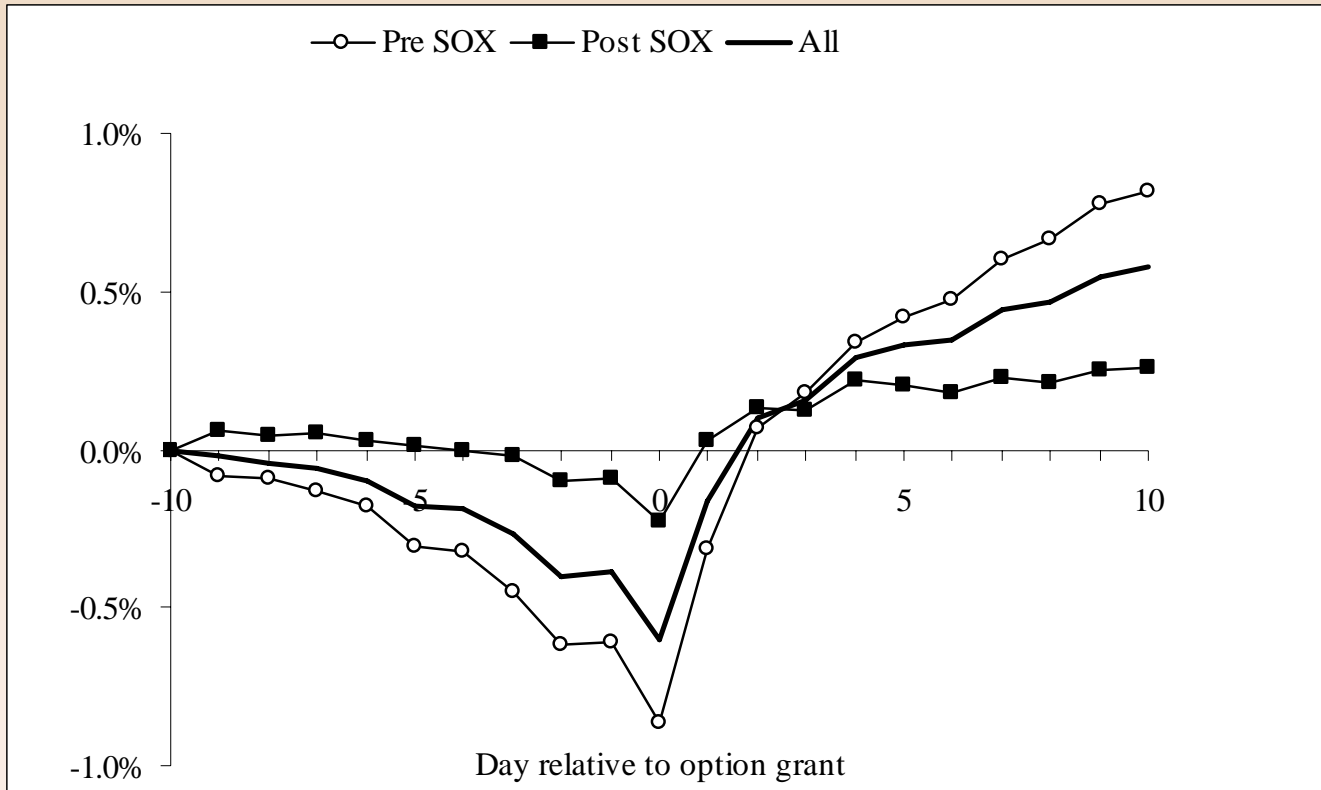


Dependent variable: Date selected as grant date

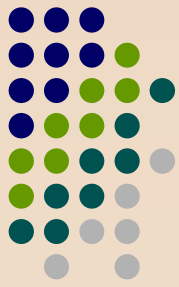
	(1)	(2)		(3)	(4)
Dummy_Lowest_price	0.514	0.565	Lowest * Before SOX	0.572	0.631
	(20.77)***	(22.23)***		(19.74)***	(21.27)***
Dummy_2nd lowest_price	0.228	0.259	2nd lowest* Before SOX	0.234	0.267
	(9.57)***	(10.49)***		(8.34)***	(9.22)***
Dummy_3rd lowest_price	0.152	0.162	3rd lowest* Before SOX	0.142	0.161
	(6.38)***	(6.55)***		(5.17)***	(5.65)***
Dummy_4th lowest_price	0.059	0.069	4th lowest* Before SOX	0.041	0.05
	(2.37)**	(2.64)***		-1.38	-1.63
Dummy_5th lowest_price	0.04	0.053	5th lowest * Before SOX	0.025	0.038
	-1.6	(2.04)**		-0.85	-1.25
Constant	-3.051	-3.059	Lowest * After SOX	0.392	0.429
	(601.36)***	(563.24)***		(10.40)***	(11.14)***
Observations	571830	519328	2nd lowest* After SOX	0.217	0.241
				(5.39)***	(5.81)***
			3rd lowest* After SOX	0.172	0.163
				(4.17)***	(3.79)***
			4th lowest* After SOX	0.098	0.107
				(2.40)**	(2.54)**
			5th lowest * After SOX	0.071	0.082
				(1.70)*	(1.91)*
			Constant	-3.051	-3.059
				(601.36)***	(563.24)***
			Observations	571830	519328



ABNORMAL STOCK RETURNS AROUND GRANT EVENTS

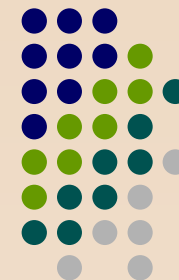


ESTIMATING THE INCIDENCE OF OPPORTUNISTIC TIMING



	Lucky (lowest)	2 nd Lowest	3rd lowest	Three lowest
Before SOX (Observations 15709)				
Actual Number of Grant Events	1707	1386	1350	4443
Expected Number of Grant Events	1098	1236	1315	3649
Actual-Expected	609	150	35	794
(Actual-Expected)/Expected	55.5%	12.1%	2.7%	21.8%
(Actual-Expected)/Actual	35.7%	10.8%	2.6%	17.9%
(Actual-Expected)/Total	3.5%	0.9%	0.2%	4.5%
Exercise Price/Median Stock Price	0.88	0.92	0.95	0.91
After SOX (Observations 10500)				
Actual Number of Grant Events	766	672	646	2084
Expected Number of Grant Events	571	591	607	1769
Actual-Expected	195	81	39	315
(Actual-Expected)/Expected	34.1%	13.6%	6.4%	17.8%
(Actual-Expected)/Actual	25.4%	12.0%	6.0%	15.1%
(Actual-Expected)/Total	1.7%	0.7%	0.3%	2.8%
Exercise Price/Median Stock Price	0.91	0.93	0.94	0.93
Overall (Observations 26209)				
Actual Number of Grant Events	2473	2058	1996	6527
Expected Number of Grant Events	1669	1827	1922	5418
Actual-Expected	804	231	74	1109
(Actual-Expected)/Expected	48.2%	12.6%	3.9%	20.5%
(Actual-Expected)/Actual	32.5%	11.2%	3.7%	17.0%
(Actual-Expected)/Total	2.8%	0.8%	0.3%	3.9%
Exercise Price/Median Stock Price	0.89	0.93	0.94	0.92

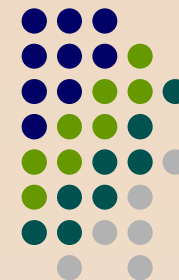
ESTIMATING THE INCIDENCE OF OUTSIDE DIRECTORS AND FIRMS ASSOCIATED WITH OPPORTUNISTIC TIMING



Distribution of Grants by Outside Directors							
# Grants	Outside Directors	Actual # Outside Directors	Expected # Outside Directors at Lowest	Actual - Expected	(Actual - Expected) / Expected	(Actual - Expected) / Actual	(Actual - Expected) / Total
		At Lowest	Lowest				
1	13140	1243	927	316	34.1%	25.4%	2.4%
2	6670	1113	829	284	34.3%	25.5%	4.3%
3	3947	918	690	228	33.1%	24.9%	5.8%
4	2430	701	535	166	31.0%	23.7%	6.8%
5 and more	4296	1920	1525	395	25.9%	20.6%	9.2%
All	30483	5895	4506	1389	30.8%	23.6%	4.6%

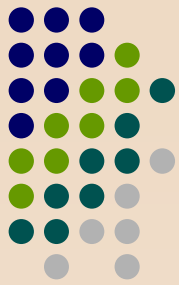
Distribution of Grant Events by Firm							
# Grant Events	Firms	Actual # Firms	Expected # Firms at Lowest	Actual - Expected	(Actual - Expected) / Expected	(Actual - Expected) / Actual	(Actual - Expected) / Total
		At Lowest	Lowest				
1	1722	207	141	66	47.0%	32.0%	3.8%
2	1146	213	153	60	39.0%	28.0%	5.2%
3	844	224	161	63	39.0%	28.0%	7.5%
4	616	204	143	61	43.0%	30.0%	10.0%
5 and more	2113	1004	797	207	26.0%	21.0%	9.8%
All	6441	1852	1395	457	33.0%	25.0%	7.1%

OUTSIDE DIRECTOR LUCK AROUND THE ECONOMY



<i>12 Fama-French Industries</i>	#Firms in Industry	#Grant Events in Industry	%Grant Events at Lowest (Lucky)	%Firm with Opportunistically Timed Grants	Regression Coefficients
Shops: Wholesale, Retail, and Some Services (Laundries, Repair Shops)	656	2923	10.4%	10%	0.162
Consumer Durables: Cars, TV's, Furniture, Household Appliances	144	623	10.3%	6%	0.154
Other: Mines, Constr, BldMt, Trans, Hotels, Bus Serv, Entertainment	809	3376	9.7%	7%	0.045
Business Equipment: Computers, Software, and Electronic Equipment	1593	7318	9.3%	9%	0.036
Consumer Non-Durables: Food, Tobacco, Textiles, Apparel, Leather, Toys	290	1270	9.1%	5%	
Health: Healthcare, Medical Equipment, and Drugs	789	4106	8.8%	7%	0.000
Telecom: Telephone and Television Transmission	207	821	8.4%	7%	-0.030
Money: Finance	1155	4281	8.4%	4%	-0.022
Manufacturing: Machinery, Trucks, Planes, Off Furn, Paper, Com Printing	557	2443	8.1%	4%	-0.086
Energy: Oil, Gas, and Coal Extraction and Products	189	743	7.5%	4%	-0.127
Chem: Chemicals and Allied Products	112	517	6.0%	2%	-0.342*
Utilities	76	343	4.7%	0%	-0.476*

BACKDATING VS. SPRING-LOADING



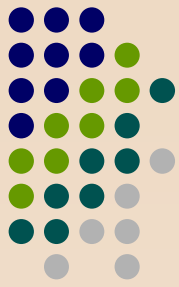
Panel A: Lowest vs Second Lowest (Months with less that 1% difference)

Dependent variable: Date selected as grant date				
Intercept	-3.014 ***	-3.02 ***	-2.851 ***	-2.811 ***
	-702.79	-642.38	-77.84	-73.93
Lowest price of the month	0.326 ***	0.384 ***	0.163 ***	0.175 ***
	-8.34	-9.48	-3.09	-3.2
Second-lowest price of the month	0.163 ***	0.209 ***		
	-4.15	-5.09		
Observations	229161	202019	27019	24039
Annual Meeting Events	Included	Excluded	Included	Excluded
Sample		All	Only Lowest and Second Lowest	

Panel B: Reported Same Month vs Reported Next Month

Dependent variable: Date selected as grant date				
Intercept		-3.013 ***	-3.016 ***	-3.005 ***
		-1291.84	-1201.75	-952.24
Lucky*Reported same month		0.302 ***	0.335 ***	0.309 ***
		-7.3	-7.9	-6.56
Lucky*Reported next month		0.541 ***	0.591 ***	0.54 ***
		-19.88	-21.21	-7.99
Observations		571830	519328	208402
p-value of F-test		0	0	0
Annual Meeting Events		Included	Excluded	Excluded

THE DETERMINANTS OF BEING LUCKY – A FIRST LOOK



Dependent variable: Lucky grant event

	(1)	(2)	(3)	(4)	(5)	(6)
	Pooled Regressions		Firm Fixed Effects		Outside Director Fixed Effect	
Relative size	-0.006 (0.48)	-0.010 (0.76)	0.086** (2.19)	0.084** (2.14)	0.051*** (3.01)	0.049*** (2.91)
New Economy	0.000 0.00	0.000 (0.01)				
Median-Minimum Price Difference	1.796*** (7.89)		1.678*** (5.60)		1.783*** (9.08)	
Market Component of the Median-Minimum Price Difference		3.587*** (4.70)		3.111*** (3.32)		2.333*** (3.88)
Firm-specific Component of the Median-Minimum Price Difference		1.697*** (7.28)		1.597*** (5.24)		1.747*** (8.74)
SOX	-0.198*** (4.12)	-0.196*** (4.08)	-0.265*** (4.07)	-0.263*** (4.03)	-0.178*** (4.25)	-0.177*** (4.24)
Intercept	-1.419*** (6.95)	-1.414*** (6.94)				
Observations	25888	25888	25888	25888	79576	79576

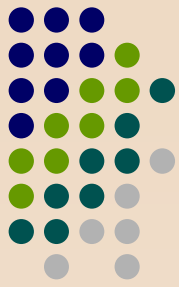
GRANT EVENT PARTICIPANTS AND OUTSIDE DIRECTOR LUCK



PANEL A: OUTSIDE DIRECTOR LUCK AND EXECUTIVE PARTICIPATION

Dependent variable: Lucky grant event

	(1)	(2)	(3)
CEO But Not Other Execs Get Grant	0.645 (2.99)***	0.645 (2.99)***	0.644 (2.98)***
CEO And Other Execs Get Grant	0.632 (7.48)***	0.657 (7.67)***	0.647 (7.58)***
Other Execs But Not CEO Get Grant	0.336 (4.26)***	0.345 (4.37)***	0.340 (4.31)***
Number of Outside Directors per Grant Event		-0.024 (1.79)*	
At Least 4 Outside Directors Get Grant in Event			-0.079 (2.24)**
SOX	-0.240 (3.66)***	-0.229 (3.49)***	-0.232 (3.53)***
Relative size	0.079 (2.01)**	0.080 (2.02)**	0.079 (2.01)**
Median-Minimum Price Difference	1.573 (5.21)***	1.579 (5.22)***	1.576 (5.22)***
Observations	25888	25888	25888

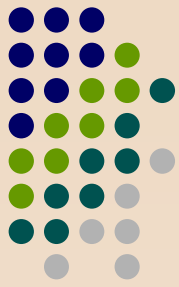


GRANT EVENT PARTICIPANTS AND OUTSIDE DIRECTOR LUCK (continued)

PANEL B: OUTSIDE DIRECTOR LUCK WITHOUT EXECUTIVE PARTICIPATION

Dependent variable: Date selected as grant event

	(1)	(2)	(3)
Lucky	0.431 (16.47)***		
Lucky *Before SOX		0.485 (15.63)***	
Lucky * After SOX		0.322 (7.78)***	
Lucky * Directors Alone in Grant Event			0.357 (12.51)***
Lucky * Directors With Non-CEO Execs			0.359 (6.35)***
Lucky * Directors with CEO			0.598 (10.61)***
Constant	-3.009 (1195.46)***	-3.009 (1195.46)***	-3.016 (1201.75)***
Observations	454649	454649	519328



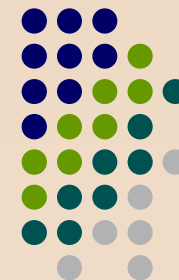
GRANT EVENT PARTICIPANTS AND OUTSIDE DIRECTOR LUCK (continued)

PANEL C: OUTSIDE DIRECTOR LUCK AND CEO LUCK

Dependent variable: Lucky grant event

	(1)	(2)
Lucky CEO this or last Year	0.286 (2.90)***	0.215 (1.69)*
Relative size	-0.024 (1.41)	0.000 (0.00)
Median-Minimum Price Difference	1.496 (4.92)***	1.657 (4.12)***
SOX	-0.061 (1.04)	-0.065 (0.77)
Constant	-1.889 (6.63)**	
Observations	18376	18376

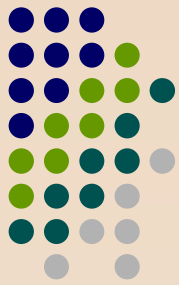
CORPORATE GOVERNANCE AND OUTSIDE DIRECTOR LUCK



Dependent variable: Lucky grant event

	(1)	(2)	(3)	(4)
Not Independent Board	0.206 (2.05)**	0.285 (2.61)***	0.288 (2.56)**	0.316 (2.73)***
Numb of Exec Directors	0.117 (1.89)*	0.149 (2.31)**	0.144 (2.01)**	0.138 (1.95)*
Boardsize	-0.039 (1.77)*	-0.068 (2.55)**	-0.060 (2.02)**	-0.058 (1.95)*
Busy Board dum	-0.399 (1.30)	-0.397 (1.28)	-0.258 (0.82)	-0.256 (0.81)
CEO tenure	0.016 (2.05)**	0.015 (1.73)*	0.016 (1.68)*	0.016 (1.69)*
CEOChair dum	0.034 (0.29)	0.039 (0.29)	0.053 (0.36)	0.044 (0.30)
Founder CEO	-0.139 (0.88)	-0.046 (0.25)	-0.022 (0.11)	-0.031 (0.15)
Insider Ownership	6.231 (2.79)***	7.192 (2.99)***	8.518 (3.03)***	8.448 (3.00)***
Insider Ownership2	-19.806 (2.67)***	-20.873 (2.69)***	-24.065 (2.65)***	-23.893 (2.62)***
High Entrenchment Index		0.478 (4.08)***	0.416 (3.14)***	0.414 (3.12)***
Fractional Ownership by Public Pension Funds			-0.053 (1.74)*	-0.053 (1.75)*
Independent Compensation Com dum				0.132 (0.64)
Independent Nominating Com dum				0.027 (0.16)
Independent Audit Com dum				-0.013 (0.07)
Relative size	0.038 (1.01)	0.054 (1.27)	0.043 (0.93)	0.041 (0.88)
Median-Minimum Price Difference	2.256 (3.58)***	2.682 (4.18)***	2.278 (3.24)***	2.284 (3.25)***
SOX	0.068 (0.60)	0.010 (0.08)	0.056 (0.37)	0.056 (0.37)
Constant	-3.301 (11.80)***	-3.296 (10.12)***	-3.213 (8.89)***	-3.337 (8.35)***
Observations	6418	5895	4581	4581

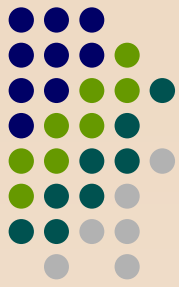
SERIAL LUCK



Dependent variable: Lucky grant event

	(1)	(2)	(3)
Previous Grant Event Lucky	0.289	0.325	0.397
	(3.55)***	(3.89)***	(1.77)*
Previous Grant Event Not Lucky	-0.218	-0.151	-0.196
	(4.37)***	(2.90)***	-1.23
Not Independent Board			0.308
			(2.71)***
Numb of Exec Directors			0.139
			(2.02)**
Busy Board dum			-0.261
			-0.84
Boardsize			-0.058
			(1.99)**
CEO tenure			0.015
			(1.70)*
CEOChair dum			0.031
			-0.22
Founder CEO			-0.036
			-0.19
Insider Ownership			8.129
			(3.00)***
Insider Ownership2			-22.832
			(2.60)***
High Entrenchment Index			0.409
			(3.18)***
Fractional Ownership by Public Pension Funds			-0.055
			(1.75)*
Independent Audit Com dum			-0.02
			-0.11
Independent Compensation Com dum			0.123
			-0.62
Independent Nominating Com dum			0.018
			-0.11
Relative size		-0.023	0.041
		(1.77)*	-0.91
Median-Minimum Price Difference		1.581	2.241
		(6.99)***	(3.21)***
SOX		-0.185	0.077
		(3.82)***	-0.51
Constant	-2.691	-2.858	-3.17
	(50.22)***	(43.77)***	(7.51)***
Observations	25888	25888	4581

Conclusion



- Option grants to outside directors have been opportunistically timed, with such timing produced to a significant extent by backdating and not merely spring-loading based on private information.
- Our results highlight that agency problems might arise not only in the relationship between executives and the boards overseeing them but also between outside directors and the public investors.
- The conditions under which outside directors operate, and not merely the classification of outside directors as such, determine whether they can be expected to perform their critical role well.