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CEO Stock Option and Product Recalls

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CEO STOCK OPTION PAY AND PRODUCT RECALLS

Business has placed considerable focus on how to compensate executives, particularly CEOs. To align the interests of shareholders and managers, firms have increasingly utilized stock options, which encourage risk taking by executives who otherwise may act conservatively to protect their jobs. While options have largely been hailed for their positive relation to shareholder wealth, recent research in the *Strategic Management Journal* suggests that stock options may have unintended consequences for consumers, because they increase the likelihood of product recalls.

Key Takeaways:

- Firms with a larger percentage of CEO stock option compensation are more likely to have subsequent product recalls and a greater number of recall incidents.
- The relationship between stock options and product recalls is weaker in firms with founder CEOs and where the CEO has a longer tenure.

Using data on 386 CEOs in the food and drug industries, the researchers analyzed the likelihood of a firm recalling a product in a given year as well as how many recalls occurred. Their analyses indicate that as the percentage of CEO stock option pay to total compensation increases, there is an increased likelihood of product recalls and increases in the number of recall events in a given year. The authors suggest these are negative consequences of stock options associated with the lack of downside risk for executives who receive such options. To further understand these effects, the researchers show that stock options have a weaker effect on product recalls when the CEO is the firm's founder or has longer tenure in the firm. These effects highlight that executives respond differently to incentives based on their characteristics.

In summary, while stock options may have value for firms to promote managerial behavior consistent with shareholder interests, unintended consequences may occur when executives seek risk. In this case, CEOs paid with stock options may overlook potential product safety concerns in order to enhance personal wealth. The authors suggest that one means to overcome these problems is through restricted stock or long-term covenants on stock options.

Source: Wowak, A.J., Mannor, M.J. and Wowak, K.D. (2015). Throwing Caution to the Wind: The Effect of CEO Stock Option Pay on the Incidence of Product Safety Problems. *Strategic Management Journal,* 36: 1082-1092.