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Role of Corporate Board Executive Pay Decisions in Precipitating Financial Crisis

Erica Beecher-Monas
Wayne State University

ROLE OF CORPORATE BOARD EXECUTIVE PAY DECISIONS IN PRECIPITATING FINANCIAL CRISIS

ERICA BEECHER-MONAS*

The focus of this essay is the role of unbridled executive pay in exacerbating the effects of what Keynes termed the "animal spirits" of the market.[1] By now, we are all intimately familiar with the effects of turbulence in our credit markets. What is less well understood is how we got into this mess in the first place. Leveraged loans, "high-risk, floating-rate loans arranged by banks, syndicated through nonbank lenders like pension, hedge, and private equity funds, and used to finance leveraged restructuring,"[2] and the feedback loop between market and firm liquidity are now thought to be a major factor. The development of a secondary market for these credit derivatives vastly changed what Frank Portnoy and David Skeel referred to as the "landscape of corporate governance."[3]

Financial institutions selling second-level securitizations misperceived the risk; senior managers, investors, and regulators all thought these instruments were riskless.[4] When the bottom fell out of the market for structured investment products based on housing finance, that also affected business finance more broadly, causing the demand for leveraged loans to drop sharply and "reducing credit access for

* Professor of Law, Wayne State University Law School. I would like to thank panelists and participants at the Southeastern Association of Law Schools annual meeting for helpful comments and critique.

1 *See* JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT: INTEREST AND MONEY 161-62 (1936).

2 Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 IOWA J. CORP. L. 447, 453 (2009) (discussing the dynamics of liquidity in firms and markets, and noting the wave of leveraged buyouts that the leveraged loan instruments funded); *see also* Greg Ip & Jon E. Hilsenrath, *How Credit Got So Easy and Why It's Tightening*, WALL ST. J., Aug. 7, 2007, at A1.

3 Frank Partnoy & David A. Skeel, Jr., *Debt as a Lever of Control: The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1051 (2007) (discussing the implications for corporate governance of an active secondary market in credit derivatives).

4 Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 12 (Univ. of San Diego School of Law, Working Paper No. 288, 2009), *available at* http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653 (noting that no bank disclosed the risk of these instruments before the crisis, and that bank directors claimed they were unaware of the risk).

private equity firms and other borrowers seeking to finance leveraged buyouts."[5] As Alan Schwartz, President and C.E.O. of Bear Stearns, explained to the U.S. Senate Banking Committee, rumors about Bear's illiquidity caused its liquidity cushion to fall precipitously as "customers withdrew cash and repo[6] counterparties increasingly refused to lend against even high-quality collateral."[7] Ultimately, the crisis in investor confidence in the "structured securities markets led to risks flowing onto banks' balance sheets"[8] and into our current financial crisis.

So what does all of this have to do with executive pay? Surely I am not going to blame the entire financial crisis on exorbitant pay? Bear with me.

In most firms, the point of aligning shareholder interests with those of senior managers through the use of compensation structures like stock options is to encourage managerial risk-taking. Stock options are meant to align the interests of management with that of shareholders, since executives will only exercise the options if the market price of the stock exceeds the exercise price, giving managers an incentive to maximize shareholder value. Thus, pay for performance is intended to correlate the firm's productivity with managerial compensation.[9]

Moreover, herding effects mean that CEOs have incentives to "ride a bubble until [just before] it bursts,"[10]continuing to engage in risky structured-financing transactions, even if they have doubts about the soundness of the strategy, since otherwise they risk losing out on substantial short-term profits. The higher the compensation, and the more closely it is tied to the price of the firm's stock, the

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[5] Ben S. Bernanke, Chairman, Fed. Reserve, Address at the Economic Club of New York: The Recent Financial Turmoil and its Economic and Policy Consequences (Oct. 15, 2007) (transcript available at http://www.federalreserve.gov/ newsevents/speech/bernacke20071015a.htm.)

[6] The term "repo" refers to a repurchase agreement, where a firm holding a security pledges it as collateral for a loan. *See* Gabilondo, *supra* note 2, at 458 (explaining that "for investment banks with large securities portfolios, the repo market is one of their most important ways of funding their activities day to day.").

[7] *Statement of Alan Schwartz, President and C.E.O. of the Bear Stearns Companies, Inc.: Hearings Before the S. Comm. on Banking*, 110th Cong. 1 (Apr. 3, 2008).

[8] Bank for Int'l Settlements, Working Group on Liquidity, Basel Comm. on Banking Supervision, *Liquidity Risk: Management and Supervisory Challenges* 11 (2008), *available at* http://www.bis.org/press/p080221.htm.

[9] LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 137-38 (2004). The most common way for firms to make this connection is to pay executives with stock options. Stock-option grants in the U.S. have grown from 27% of executive pay packages in 1992 to over 50% today. *See* Jeffrey N. Gordon, *Say on Pay: Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 328 (2009).

[10] Richard A. Posner, *Are American CEOs Overpaid, and, if so, What if Anything Should be Done About It?*, 58 DUKE L.J. 1013, 1041 (2009).

greater the incentive to ride that bubble. And if the CEO fails to jump off in time, there's always his golden parachute.

Moreover, stock-based compensation is a double-edged sword, giving managers an incentive not only to increase production effort, but also to increase the diversion of firm assets.[11] The ability of managers to choose the timing of their stock sales and sell large amounts of stock over a short time period presents the dilemma of giving managers the incentive to manipulate the stock price before selling.[12] The options misdating scandals that preceded the financial meltdown – both backdating and springloading – amounted to stealth compensation.[13] Why play dating games if the CEOs are really performing? Narayanan, Schipani, and Seyhun demonstrate that the revelation of backdating results in an average loss to shareholders of about seven percent, translating to $400 million per firm, while executives gain from these manipulations an average of $500,000 per firm per year, demonstrating inefficient compensation and incorrect incentives.[14] Although SOX was supposed to curtail this abuse by requiring disclosure of option grants within two days of the grant, Narayanan, Schipani, and Seyhun contend that it has not had the desired effect because a significant number of firms making grants of over 500,000 options delayed reporting. The authors suggest that the best way to limit this practice is to require companies to report both the date that the board or compensation committee finalized the award details and the grant date that it decided.[15]

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[11] *See generally* Eitan Goldman & Steve Slezak, *An Equilibrium Model of Incentive Contracts in the Presence of Information Manipulation*, (EFA 2004 Maastricht Meetings, Working Paper No. 3206, July 5, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=465201.

[12] *See* Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 454-55 (2008) (contending that existing legal rules and compensation arrangements do little to solve this problem, and suggesting that boards adopt a policy of announcing a fixed gradual schedule for cashing out executive options, removing executives' control over the timing of equity sales).

[13] *See* M.P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options,* 105 MICH. L. REV. 1597, 1600 (2007) (concluding that these mispricing games are the result of board capture).

[14] *Id.* at 1638.

[15] *Id.* at 1640. The new amendments appear to address this problem by requiring disclosure of the grant date and the decision date of the options, as well as disclosure of the fair market value on the grant date and closing market price on the grant date if it is greater than the exercise price. In addition, the methodology for determining the exercise price must be disclosed if the exercise price is not the grant date closing market price per share. *Id.* The authors point out, however, that the amended disclosure rules do not limit springloading (scheduling an option grant right before a positive news release, or right after a negative one), and they suggest that annual option awards should be divided into monthly installments and awarded along with the executive's basic salary. *Id.* Springloading is addressed in the new disclosure rules first by requiring tabular disclosure of fair value of stock option grants, as well as a separate column if the exercise price differs from the stocks's

Furthermore, despite the rhetoric of pay for performance, there appears to be little effort to adjust pay downward for poor performance. The departures of Stanley O'Neal from Merrill Lynch and Charles Prince from Citigroup with munificent separation packages, including the vesting of equity grants, are more emblematic of pay for failure than of pay for performance.[16] Bank of America, recognizing that its CEO, Kenneth Lewis, missed performance goals in 2007, cut his bonus to $8.5 million from the target bonus of $18.5 million.[17] That does not include his $1.5 million base salary or $3 million in options awards.[18] At Morgan Stanley, although the CEO did not get a bonus, the firm's overall compensation and benefits expenses rose 18% in 2007 despite a six percent decrease in revenue.[19] On the eve of its government-sponsored (and funded) takeover by Bank of America, Merrill Lynch's board awarded $3.6 billion in incentive bonuses.[20] All of this rising pay – all theoretically linked to performance – occurred within a heartbeat of the current financial implosion, implicating each of these firms.

And the outrage over stupendous executive pay following the Troubled Asset Relief Program ("TARP") does not seem to have stopped the feeding frenzy. Citi paid $5.33 billion in bonuses in 2008, despite losing $27.7 billion and receiving $45 billion in the bailout.[21] Bank of America, a recipient of $45 billion from TARP, paid out $3.3 billion in bonuses.[22]

As a result of the short-term focus on pay period rather than long-term results, as well as the heavy use of stock options in paying executives, the upside potential for profits became unlinked to the risk of loss. Linking pay to short-term gains through options appears to magnify the risk that executives are willing to take, since they are compensated for stock price increases, but – unlike shareholders –

market price on the day of the grant, and second by explicitly requiring disclsoure in the Compensation Discussion and Analysis (CD&A) of any program, plan, or practice of coordinating grant dates with the release of material, non-public information. 17 C.F.R. § 229.402(b)(1)(i) (2009).

16 Despite the tanking of their firms, Prince left Citigroup with about $29.5 million, and O'Neal (whose departure from Merrill was deemed "retirement") left with $36.8 million in immediately vesting options, $25 million in retirement benefits, and $5 million in deferred compensation. *See* Bimal Patel, *Credit Crisis and Corporate Governance Implications: Guidance for Proxy Season and Insight into Best Practices*, RISKMETRICS (Apr. 2008), http://www.riskmetrics.com/system/files/private/CreditCrisisCorporateGovernance20080408.pdf.

17 Peter Edmonston, *Major Bank Cuts Bonuses of Executives*, N.Y. TIMES, Mar. 20, 2008, at C2.

18 *Id.*

19 Bloomberg News, *Morgan Board Loses Support*, N.Y. TIMES, Apr. 5, 2008, at C8.

20 Louise Story, *Judge Rejects Settlement Over Merrill Bonuses*, N.Y. TIMES, Sept. 14, 2009, at B15.

21 Editorial, *Troubled Banks, Huge Bonuses*, N.Y. TIMES, Aug. 3, 2009, at A20.

22 *Id.*

they are not punished for decreases in stock price. This also increases the CEO's incentive to increase firm leverage, which will magnify potential returns on firm investments.[23] This kind of compensation structure may threaten the safety of the firm. As Richard Posner remarked, a "CEO cushioned against loss has an incentive to take high risks in order to maximize the expected value of his stock options."[24] But, in financial firms, compensation structures that encourage risk-taking may threaten the safety and soundness not only of the particular firm, but of the entire financial system.[25]

Financial firms typically pay their senior managers "zero and fifty," or 50% of their trading profits and losses.[26] Thus, it would seem that pay is already a function of performance in these firms. However, the questions of what constitutes performance and how it should be measured are important ones in assessing whether risk and performance are correlated.

First, if performance is being measured by scrutinizing quarterly earnings reports, the result will be excessive pressure to make those numbers look good. This provides incentives to pursue short-term gains at the expense of long-term benefits. Moreover, a short-term-pay-period focus means that the long-term consequences of risk-taking are often overlooked. Although clawback provisions to performance-based executive pay, written into Sarbanes-Oxley in response to the previous financial crisis involving Enron and WorldCom (among others), should have warned compensation committees and executives about the dangers of a short-term perspective, short-term practices continued unabated.[27] Even with a clawback provision or payouts over time to account for risk, however, super compensation creates conflicts of interest.[28]

Some financial firms did attempt to take risk into account when measuring performance.[29] The risk that was being measured, however, was risk to the particular

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[23] Posner, *supra* note 10, at 1041.

[24] *Id.* at 1027.

[25] Gordon, *supra* note 9, at 365 (noting that while Enron was brought down at least in part by misguided compensation strategies, that failure was internalized, while the failure of Lehman reverberated through the system).

[26] *See id.* at 364.

[27] *See, e.g.,* The Aspen Institute Corporate Values Strategy Group, Long Term Value Creation: Guiding Principles for Corporations and Investors (2007), http://www.aspeninstitute.org (type "Long Term Value Creation" in search box).

[28] *See* Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 562-63 (2009) (noting that financial independence implies a potential divergence of individual and firm interests).

[29] Value at risk (VAR) is a quantitative model that risk managers use to quantify a firm's (or a trader's) risk position, measured as a dollar figure. Joe Nocera, *Risk Mismanagement*, N.Y. TIMES, Jan. 4, 2009, at MM. The problem with such models is that they are based on assumptions that may not be

firm, rather than systemic risk. Moreover, there is strong temptation to compensate for production without taking even firm-wide risk adequately into account. More importantly, none of these measures focuses on systemic risk.

Currently on the table, for example, is whether the Treasury Department should allow the payment of a $100-million bonus to Andrew J. Hall, CEO of a Citigroup subsidiary, in light of the $45-billion taxpayer bailout to Citigroup.[30] Should this senior executive bear some of the financial responsibility for the parent firm's predicament? For a portion of the entire TARP bailout? Jeffrey Gordon argues that financial firms' compensation structures are so important systemically that the board should be required to obtain independent risk management consultants in setting compensation.[31]

As a result of the crisis, several steps are being taken with regard to executive pay. TARP limits executive compensation and golden parachutes, and requires compensation committees to take a long-term view of firm performance for those firms accepting the government bailout. [32] On July 10, 2009, the SEC proposed amendments to its executive compensation disclosure rules.[33] The SEC is examining "say-for-pay" provisions, permitting shareholders to advise the board on executive compensation. British regulators recently issued rules governing bonus payments by banks, prohibiting bonuses guaranteed for more than one year or that are several times the banker's salary, with penalties of fines or increased capital requirements because such pay models are deemed to be risky.[34] But whether any of these provisions will effect meaningful change is an open question, especially in light of a recent study showing that short-term incentives played an even bigger role in setting executive compensation in the 2009 proxy season than they had previously.[35] Long-term programs actually have been reduced.[36] There are good reasons to be wary

accurate. For example, in valuing mortgage-backed securities, the model used home price escalation assumptions based on the prior two years: the height of the housing bubble. *Id.* Moreover, VAR measures only the short term; it does not measure liquidity risk. Plus, it can be gamed, especially with credit-default swaps; because they have constant small gains and rarely have losses, the model ignores the losses. But the losses can be huge.

[30] David Segal, *Trader's $100 Million Payday Poses Quandary for Regulator,* N.Y. TIMES, Aug. 2, 2009.

[31] Gordon, *supra* note 9, at 366.

[32] Emergency Economic Stabilization Act, 12 U.S.C. § 5221 (2008) (setting standards for executive compensation and corporate governance for firms that sell troubled assets to the government under this Act).

[33] Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270, and 274).

[34] Julia Werdigier, *British Regulator Issues Rules on Bank Bonuses,* N.Y. TIMES, Aug. 13, 2009, at B4.

[35] Gretchen Morgenson, *The Quick Buck Just Got Quicker,* N.Y. TIMES, Aug. 16, 2009, at B1.

[36] *Id.*

about government involvement in regulating executive pay.[37] On the other hand, public outrage over the behavior of corporate boards in setting executive pay may make a legislative response inevitable.

This essay has raised questions that I hope to explore more fully in a later article. What were the effects of board group dynamics on several questions relevant to the current financial crisis? Board capture is the most prevalent explanation for high levels of CEO pay.[38] Can that also explain why boards of financial institutions were so complacent about risky investment strategies that their firms were undertaking? What is the effect of herding behavior on small group dynamics engaging in risk appraisal? And what is the link between executive pay and such strategies? Why, after Enron, did any board trust the opaque and complex financial instruments that were at the core of the crisis? What should be done? This work is still in its (very) early stages, and more questions that need to be explored will doubtless arise.

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37 Mark A. Borges et al., *The Need for a Principled Approach to Compensation Reform*, CORP. ACCOUNTABILITY REP. (BNA), Aug. 7, 2009, at 108.

38 *See* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 156-64 (1996); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901 (2001).