

Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay

Law Working Paper N° 161/2010

July 2010

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Columbia Law School and European Corporate Governance Institute

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Thanks to Patrick Bolton, Ron Gilson, Rob Jackson, Kate Judge, and Holger Spamann for exceptionally helpful comments and conversations on this paper. Correspondence should be addressed to: jgordon@law.

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Abstract

Unlike the failure of a non-financial firm, the failure of a systemically important financial firm will reduce the value of a diversified shareholder portfolio because of an increased level of systemic risk. Thus diversified shareholders of a financial firm generally internalize systemic risk whereas managerial shareholders and blockholders do not. This means that the governance model drawn from non-financial firms will not fit financial firms. Regulation that limits risk taking by financial firms can thus provide a benefit, rather than necessarily impose a cost, for the typical diversified public shareholder. Managerial shareholding also gives rise to particular problem of the CEO who, despite the increasing precariousness of the firm's position, may be reluctant to pursue equity infusions or to sell the firm because of the consequent dilution of his ownership stake. This might be called the "Fuld problem." To mitigate excessive risk-taking both in ordinary operations and as the firm approaches financial distress, the paper proposes a new compensation mechanism for senior managers, convertible equity-based pay. Upon certain external triggers, such as a downgrade into a high risk category by regulators or a deterioration in a key financial ratio, such stock-based compensation should convert into subordinated debt, at a valuation discount. This will give managers an incentive to curb excessive risk-taking and in particular to steer the firm away from financial distress.

JEL Classification: E61, G28, G32, J33, K22, M52

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Unlike the failure of a non-financial firm, the failure of a systemically important financial firm will reduce the value of a diversified shareholder portfolio because of an increased level of systemic risk. Thus diversified shareholders of a financial firm generally internalize systemic risk whereas managerial shareholders and blockholders do not. This means that the governance model drawn from non-financial firms will not fit financial firms. Regulation that limits risk taking by financial firms can thus provide a benefit, rather than necessarily impose a cost, for the typical diversified public shareholder. Managerial shareholding also gives rise to particular problem of the CEO who, despite the increasing precariousness of the firm's position, may be reluctant to pursue equity infusions or to sell the firm because of the consequent dilution of his ownership stake. This might be called the "Fuld problem." To mitigate excessive risk-taking both in ordinary operations and as the firm approaches financial distress, the paper proposes a new compensation mechanism for senior managers, convertible equity-based pay. Upon certain external triggers, such as a downgrade into a high risk category by regulators or a deterioration in a key financial ratio, such stock-based compensation should convert into subordinated debt, at a valuation discount. This will give managers an incentive to curb excessive risk-taking and in particular to steer the firm away from financial distress.

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¹ Alfred W. Bressler Professor of Law, Columbia Law School. Fellow, European Corporate Governance Institute. Thanks to Patrick Bolton, Ron Gilson, Rob Jackson, Kate Judge, and Holger Spamann for exceptionally helpful comments and conversations on this paper. Correspondence should be addressed to: jgordon@law.columbia.edu

Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay

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The Financial Crisis raises the question of whether the traditional tools of corporate governance are adequate to address potentially perverse effects of executive compensation in financial firms. The argument for regulatory intervention is that the usual focus of corporate governance – to align the incentives of managers and shareholders – does not work sufficiently to constrain financial firm risk taking. This is because shareholders are not said not to internalize the costs of systemic risk associated with financial firm failure.¹ The problem is exacerbated by the moral hazard concerns associated with “too big to fail.” The prospect of government rescue lowers the cost of capital for large financial firms, increases the resources they deploy, and thus exacerbates the systemic harm of their failure. This compounds the stakes in compensation design. We have reasonably effective compensation models for aligning managerial and shareholder incentives but not for building in an exception for “excessive” risk-taking that may arise because of this purported failure of internalization peculiar to financial firms.

This essay does four things. First, it offers a new account of the weakness of corporate governance tools in addressing executive compensation in financial firms. The problem is not the failure in fact of systemic risk internalization -- diversified shareholders do indeed face this risk -- but the intellectual failure to appreciate the gap between shareholder and managerial interests, which is unusually wide for systemically significant financial firms. There is thus a "business case" for corporate governance activism by institutional shareholders to address compensation structures that exacerbate systemic risk. Regulatory intervention is necessary because of shareholder collective action problems, agency problems within managerial capitalism, and the diversity of shareholder interests within firms and across firms. But rather than imposing costs on shareholders in the name of systemic stability, regulatory intervention can provide a benefit to diversified shareholders.

Second, this essay identifies a new problem in executive compensation in the financial firm, namely, the disincentives of senior managers with substantial equity investments in the firm to negotiate substantial new equity raises or the sale of the firm that would be substantially

¹ See Jeffrey N. Gordon, “Say on Pay”: Cautionary Notes, 46 Harv. J. Legis. 323, 365 (2009); Lucian A. Bebchuk & Holger Spamann, Regulating Bankers’ Pay, 98 Geo. L. J. 248 (2010).

dilutive of their equity positions. This might be called the "Fuld problem." Contrary to the some recent claims, a key systemic risk problem was not that executives at Lehman and Bear Stearns had insufficient stake in their firm's survival because they were playing with "house money," having extracted large sums through cash payments and stock sales in prior years.² Rather, the critical point from the perspective of systemic risk mitigation was that their firms ran into financial difficulty, these executives' large equity stakes created an ever-widening gap between their interests and the interests of non-managerial shareholders (as well as the social interest). A CEO with large equity stake would face a much greater proportionate wealth loss than a diversified shareholder from a dilutive capital raise or sale; a diversified shareholder would face a much greater proportionate wealth loss from the systemic distress that would follow the failure of a systemically important firm.

Third, this essay offers a new compensation mechanism, "convertible equity-based compensation," that can at least partially address some of the managerial incentive problems in financial firms. The general idea is for management's equity-based stakes to convert to subordinated debt upon certain triggering events, for example, a downgrade into a "high risk" category by the financial regulator or a stock price decline of a particular percentage. Such a mechanism should constrain managerial risk-taking generally and should particularly change managerial decision-making as the firm's financial situation becomes more precarious. It solves the "Fuld problem." Both these change in managerial incentives should reduce systemic risk.

Finally, fourth, this essay explains why boards should adopt such a compensation mechanism. This is because the board has distinct fiduciary duties as the financial firm approaches the zone of insolvency. Precisely because of the widening gap between the interests of managers with large undiversified equity stakes and the public shareholders who presumptively are diversified, the board needs to intervene, for similar reasons that call forth special board action in a management buyout. The board can use an *ex ante* approach like convertible equity-based pay or it can assume direct responsibility for equity-raising decisions or the sale of the firm.

I. Corporate Governance and Executive Compensation at Financial Firms

A. Financial Firm Shareholders and Systemic Risk

The claim that shareholders would, as an *a priori* matter, have insufficient incentives to constrain "excessive" managerial risk-taking in the financial firm rests on a model of shareholder-manager interaction in the non-financial firm that does not fit in the case of financial firms. The standard account contemplates an incentive mismatch between risk-neutral (because diversified) shareholder principals and risk-averse managers. Thus the challenge, from the

² Compare Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 10 *Yale J. Reg.* (forthcoming summer 2010).

shareholder point of view, is how to encourage managers to take all positive net present value investment opportunities despite the likelihood that some will turn out badly with the consequent risk of the firm's insolvency, which may destroy the managers' firm-specific human capital investment. Equity-based pay is the common solution to this problem; put the managers in the shareholders' shoes.³ But this set-up rests on the critical assumption that the firm's failure will not otherwise affect the diversified investor's portfolio in any directional way. Competitors of the failed firm may do better; suppliers to the failed firm may do worse, but the consequences are "unbiased." If all firms are taking good bets, however, then on average the diversified investor will be better off. This is not the case in the case of the failure of a systemically significant financial firm. As we have recently seen, such a failure has powerful systemic effects. The outbreak of systemic distress can depress values throughout the diversified portfolio.

More technically: Asset pricing models generally specify that shareholders are compensated for bearing systemic risk (and perhaps other sorts of risk). The standard model generally assumes that the level of systemic risk is not affected by the failure of any particular firm. This is not the case for systemically important firms. The failure of one such firm will increase the likelihood that other financial firms will fail, via contagion or commonality.⁴ This in turn will lower the expected profitability of many non-financial firms via knock-on effects from contraction in the financial sector. In short, the failure of a systemically important financial firm can lead to a resetting of systemic risk levels, thus an increase to the systemic risk-bearing premium, and thus value reductions across a diversified portfolio.

This is a point with far-reaching implications. Managers with who have large equity positions in their firms are importantly different from the diversified public shareholder. Such managers do not internalize sufficiently the consequences of systemic distress because their financial as well as human capital investments may be undiversified. Indeed, a major thrust of recent compensation reform has been to increase the managerial "skin in the game," in particular to want greater sensitivity of managerial wealth the firm's performance. As the financial firm heads for trouble, this opens a gap between the managers who do not internalize the systemic risk of the firm's failure and the shareholders who do.

³ This is not necessarily optimal from the creditors point of view, since they internalize some of the risk of business failure. But the standard model assumes that creditors, generally, will "adjust," via compensatory interest rates or protective covenants.

⁴ "Contagion" refers to how the failure of one financial firm could, because of interfirm credit relationships, significantly increase the solvency risk of other financial firms as to trigger a cascading series of runs. "Commonality" refers to how the information revealed from the failure of one financial firm may increase the run risk at firms following a similar asset and liability strategy. Uncertainty about the extent to which particular firms are exposed to these sources of systemic risk contributes to the run cascade. See Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: The Case for a Systemic Emergency Insurance Fund*, 11 Yale J. Reg.(forthcoming winter (2011)).

This analysis points to two areas of incentive incompatibility, first as to the general risk profile of the financial firm and second as to decision-making when the firm faces financial distress. The “wedge” in the design of optimal compensation is not between {managers-and-shareholders} and society generally, but between managers and {shareholders-and-society}.

Now to reframe the point in governance terms: The standard model of executive compensation drawn from non-financial firms is that systemic risk levels are not changed by terms of the shareholder-manager contract. This follows from the observation above that systemic risk levels are not affected by individual firm failure. Assuming all actions are positive present value bets, “excessive” managerial risk-taking is not a coherent idea for the non-financial firm. But that is not the case for a systemically significant financial firm, *even from the shareholder point of view*. Thus a compensation mechanism that can reduce systemic risk will redound to the diversified shareholder’s benefit, even if the consequence is to reduce positive net-present value risk-taking at a specific firm.

B. Corporate Governance in the Financial Firm

The argument thus far is that there is a distinct “business case” for shareholder governance activism to shape the management compensation contract so as to mitigate systemic risk. Economically-motivated shareholders as well as socially-responsible shareholders have a stake in the outcome. Even though shareholders may not internalize all of the costs of systemic distress (because there are losses beyond portfolio losses, for example the human costs of higher unemployment and costs that ramify internationally), their internalized losses are sufficient to justify appropriate measures to control financial firm risk-taking. Regulation is necessary to curb excessive risk-taking by managements in systemically important financial firms because of the limits of collective shareholder action, especially by diversified shareholders, not because shareholder incentives are generally misguided.⁵ On this view, the regulator provides the

⁵ Another basis for government regulation is that shareholders will not sufficiently internalize systemic risk because they expect government intervention that will prevent the failure of any systemically important firm, or a variant, government action that will permit the failure of a single systemically important firm but will then intervene to prevent the follow-on failure of other systemically important firms. The emerging financial regulation reform legislation aims to eliminate these variants of “too big to fail.” Whether this containment will be successful, or is even wise, is a question some later crisis will demonstrate. But the diversified shareholder would benefit from risk-avoiding regulatory restrictions on executive compensation that avoided a scenario testing the credibility (and wisdom) of the “no bailouts” posture where the stakes were a major outbreak of systemic distress.

Yet another ground for regulation is a belief that shareholders will be myopic -- that shareholders will not understand their long term best interests, especially with regard to extreme outbreaks of systemic distress which are high salience for a while and then recede. Regulators too will suffer from myopia. Regulation can embed systemic risk internalization awareness – “lessons learned” -- into rules that may survive beyond the myopic calculation of subsequent actors.

Finally regulatory intervention is justified to provide systemic stability against the inherent fragility of banks and similarly-situated non-banks arising from the liquidity mismatch between asset and liabilities. Runs can occur even

necessary coordination to obtain shareholder objectives. Well-crafted regulatory intervention in this realm is a benefit to diversified shareholders, not a cost.

The limits to effective shareholder action are well known. They fall into three categories. First, dispersed shareholders are subject to important collective action problems in facing management, including but not limited to management's agenda control and the regulatory barriers to shareholder coordination. Some collective action problems have been mitigated by the rise of institutional ownership, the liberalization of the proxy rules, the role of proxy advisory services, and the activity of trade associations like the Council on Institutional Investors. New legislative mandates that strengthen shareholder voice on pay-setting ("Say on Pay") and board composition (majority voting for directors) provide new routes for shareholder initiative on compensation practices. Nevertheless, the institutional preference for liquidity over control will limit the extent to which many institutions are willing to undertake governance action.⁶

Second, the problems of "agency capitalism" open a gap between the interests of diversified shareholders like pension funds and endowments and their internal investment managers or portfolio managers. Those managers are judged by whether they can deliver "superior" performance, generally measured over a relatively short time frame. Commonly a manager's performance is tested against a benchmark, so that their concern is not the market's total performance but their relative performance against the benchmark. If they are underweight in stocks that are particularly hard hit by systemic distress they have "out-performed," even if the portfolio has significantly declined. Mutual funds, because of compensation arrangements more attuned to the size of asset pools under management, may be more sensitive to absolute returns, but their governance activism may be restrained by the conflicting desire to provide retirement plan management services to corporations.

Third, the diversity of interests among shareholders may lead to disagreement as to ideal governance arrangements. For example, although activist hedge funds have incentives to pursue firm-specific operational or management changes that will increase the value of the firm, the time frame over which their performance is evaluated by hedge fund investors may bias their activism in favor of measures that maximize short term shareholder returns.

But governance activism in financial firms is subject to a special clash of shareholder interests that turns upside down the standard models of the benefits of blockholders in corporate governance. A large shareholder – a blockholder -- in a systemically important financial firm is

where risk taking is not "excessive," meaning not driven by the mismatch between private gains and social losses. This fragility is mitigated by deposit insurance and safety and soundness regulation.

⁶ John C. Coffee, Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991).

probably undiversified.⁷ The deviation from diversification is probably increasing in the percentage of ownership. Such a shareholder will internalize a smaller share of systemic risk relative to specific firm risk.⁸ A blockholder may present very much the same problem as management: willing to take “excessive” risk because it internalizes the full upside but not much of the systemic downside. Thus for such a financial firm, the key divide is not between shareholders with “short term” vs. “long term” horizons, but between diversified and undiversified shareholders. The deep irony is that the blockholder with enough clout to constrain managerial agency costs – the objective of conventional corporate governance – also has incentives to promote “excessive” risk-taking.

This clash re-introduces a particular sort of collective action problem in which the interests of the “large shareholder” (undiversified) minority can outweigh the interests of the “small shareholder” (diversified) majority. This is because the large shareholder will have greater incentives to invest resources in firm-specific governance activism that is likely to influence managerial behavior. Put otherwise, large shareholders, whether they are “patient” shareholders or “short-termist” hedge funds, will have disproportionate influence because their highly salient activism may threaten managerial reputation and careers. For non-financial firms this is not necessarily a problem so long as managers are pushed to pursue positive net present value projects.⁹ It can be a big problem in a systemically significant financial firm if influential shareholders do not adequately internalize systemic risk. In terms of the “wedge” described above, the alignment should be restated as: {managers-and- large- (undiversified) shareholders} versus {diversified-shareholders- and-society}. Thus depending on its source, corporate governance activism in financial firms might well promote business strategies and associated compensation arrangements that would lead to excessive risk-taking.

The peculiar political economy of corporate governance means that the preferences of the diversified majority of shareholders may lose out to the distinctly different preferences of concentrated minority shareholders. That welfare-reducing outcomes can emerge from the divergent interests of the organized minority and the relatively disorganized majority is a well-

⁷ Even 1 percent ownership of a relatively small financial firm like Lehman Brothers, \$47 billion at its peak, would challenge the diversification strategy of all but the very largest investors.

⁸ Vehicles like total return swaps that substitute for direct stock ownership can also increase firm-specific exposure, reduce diversification, and thus increase the ratio of specific firm to systemic risk.

⁹ This observation is more rigorously stated in terms of the so-called “unanimity theorem,” in which under conditions of complete markets, all shareholders should want the same thing: to maximize the share price. See Mark A. Satterwaite, On the Scope of the Stockholder Unanimity Theorems, 22 Int’l Econ. Rev 119 (1981); Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 NYU L. Rev. 761, 833 n.199 (1985); Jeffrey N. Gordon, Shareholder Initiative, 60 U. Cin. L. Rev. 347, 368-70 (1991).

understood result in the political realm. The differential internalization of systemic risk brings this problem directly into the governance of the financial firm as well.¹⁰

This opens a space for regulation to defend the interests of diversified shareholders (and the social interest) by constraining excessive risk taking that may be the result of -- not reflect a shortfall in -- the influence of large, undiversified shareholders. But regulation is necessary not only because of the diversity of shareholders within firms, but also across firms. Block-holder dominated firms are likely to engage in greater risk-taking than other firms. This increases the risk of firm failure, which could impose systemic costs on diversified shareholders (and others). But the probable higher returns from a higher risk strategy will also put pressure on all firms to engage in great risk-taking, even firms owned by diversified shareholders. This also increases the likelihood of systemic distress.

The distinctive political economy of financial firm shareownership may affect not only financial firm governance but also the regulatory intervention that could address the consequences of this governance conflict. The same clash of shareholder interests can also distort the regulatory process, since large (undiversified) shareholders may be willing invest greater resources into shaping the regulatory outcome, as noted above. One cautionary note for regulators is: watch carefully which shareholders you pay attention to.

II. A New Compensation Problem in the Financial Firm

A distinct problem in the management of systemic risk in the financial firm is the CEO's equity ownership. The prior section discussed how management's stock ownership can increase the gap in systemic risk-bearing with diversified shareholders. But the impact of a large management equity stake, especially a large CEO stake, becomes particularly important as the firm faces the onset of financial distress. This is a moment when systemic risk considerations would argue for an immediate infusion of equity capital to stabilize the firm, but the CEO's personal wealth calculus argues against such dilution. This might be called "the Fuld problem": a CEO is who is reluctant to negotiate a large equity raise (or sell the firm) because the terms would massively dilute his personal equity stake and who instead may calculate that holding out for a fortuitous turn in markets or regulatory forbearance has a higher expected payoff for him.¹¹

¹⁰ Conceivably there is significant differential internalization of systemic risk of diversified shareholders versus blockholders even for non-financial firms. Imagine that blockholders push firms to follow a high leverage strategy or a particular operational strategy (e.g., disaggregated supply chains) that successfully increases shareholder returns at some firms but that if disseminated widely will have systemic effects (e.g., greater exposure to the business and interest rate cycle), which diversified shareholders will internalize but blockholders may not. Pension funds and hedge funds make for uneasy partners in corporate governance, less on the dimension of time frame than diversification.

¹¹ I merely speculate that Richard Fuld's decisions with respect to possible equity suppliers including Korean Development Bank might have been influenced by these incentives. (The problem could also have been labeled the "Cayne problem," since there are published claims that Jimmy Cayne did not pursue opportunities to raise capital or

When expected creditor losses are taken into account, this is a negative net present value strategy that replays the familiar debt-equity agency problem. When systemic distress costs are taken on board, the impact of this incentive mismatch is highly consequential.

The incentive mismatch is even more acute if the CEO has private information of greater financial trouble than is currently reflected in the market price. He would calculate that this would be revealed in the negotiations (and due diligence) over the equity raise or the sale. Not only would this entail further dilution but such information would become generally known, which could negatively affect the firm's stock market price as well as counterparty relationships and generally restrict the CEO's capacity to play for a fortuitous market turn or regulatory forbearance.

The CEO's reluctance may also stem from behavioral effects exacerbated by his large ownership stake: over-optimism bias about his ability to avoid the firm's failure without a dilutive equity raise; availability bias ("this is like the other crises I've steered the firm through"); or loss aversion framed by the valuation high point of the CEO's ownership stake. Regardless of whether the CEO is a cold calculator or in the thrall of delusion, the reluctance to accept dilution imposes default risks on creditors and systemic risks on diversified shareholders.

This analysis rejects the view that prior equity sales or cash bonuses would make a CEO relatively indifferent to the risks to his remaining substantial equity position. If so, the CEO would not fight so hard to avoid dilution. Rather, the creditors of Lehman Brothers and the taxpayers (though not necessarily the Lehman shareholders) would have been better off had Fuld sold *all* his stock in the prior years. At least his financial stake would not have been in opposition to his reputational stake.

III. A New Compensation Mechanism: Convertible Equity-Based Pay

The essay thus far has identified two distinct moments of excessive risk-taking associated with equity-based executive compensation: in the general operation of the firm and in the corporate finance decisions taken as the firm faces financial distress. This section sketches and rejects two possible reforms, including a recent proposal by Bebchuk and Spamann, and offers a new compensation mechanism, "convertible equity-based pay." Upon certain trigger points associated with incipient financial distress, senior managers' equity-based compensation would convert into subordinated debt.

sell Bear Stearns.) There is ample evidence that parties believe that the CEO responds to such incentives. The change-in-control provisions of golden parachutes, which contemplate among other things the payment of three-x salary and the acceleration of vested options, are commonly explained as incentive alignment devices that induce managers to give up the private benefits of control as well as their perhaps overly-optimistic beliefs about the firm's intrinsic value.

A. Proposal One: Eliminate Equity-based Pay For Senior Managers of Systemically Important Financial Firms

One compensation reform that would reduce risk-taking in systemically important financial firms is to pay senior managers like bureaucrats.¹² Practically speaking, this would mean the elimination (or substantial cutback) of equity based compensation for the CEO and his (or her) senior management team (and presumably an increase in fixed salary). Stock ownership by senior managers, especially large stakes, increases risk appetites in which the upside is internalized and the downside systemic risk costs are socialized. The shift into restricted stock (vs. stock options) or the requirement of long-term holding periods affects this systemic risk mismatch only at the margin. Ironically, longer holding periods may exacerbate the Fuld problem.¹³

This is not a likely endpoint of compensation reform. Among other things, in light of the range of financial firms that may be systemically important – Bear was not a particularly large firm -- such a rule would dramatically reduce financial incentives throughout financial services industry. It could invite regulatory arbitrage in which much financial activity is shifted away from firms that regulators designate as “systemically important” to other firms whose systemic importance becomes apparent only too late.

B. Proposal Two: Tie Senior Management Compensation to the Value of the Firm’s Debt and Equity

Bebchuk and Spamann have observed the mismatch between systemic risk and firm-specific shareholder objectives and have proposed a compensation formula for financial firms that would tie senior executive compensation to the value of the firm’s senior securities as well as its equity.¹⁴ This would in effect ask managers to maximize the enterprise value of the firm, not its equity value. Given incentives to protect creditor claims as well as to increase shareholder value, managers will therefore be less likely to engage in excessive risk taking. This could operationalize a compensation approach that mitigated the systemic risk faced by diversified shareholders, so it might well fit a corporate governance agenda (though undiversified shareholders would oppose). But Bebchuk and Spamann contemplate that regulatory implementation would be necessary and I agree.

Although interesting, the Bebchuk-Spamann approach has serious flaws. First, it would place a burden on regulators to define the elements of the firm’s capital structure that would be

¹² Compare Brian J. Hall & Jeffrey B. Liebman, Are CEOs Really Paid Like Bureaucrats?, 113 Q. J. Econ. 653 (1998).

¹³ If the CEO was unable to take out *any* substantial wealth from the firm this could reduce risk-taking in on-going operations and possibly at the recapitalization moment. This itself is an extreme proposal.

¹⁴ See Lucian A. Bebchuk & Holger Spamann, Regulating Bankers’ Pay, 98 Geo. L. J. 248 (2010).

included in the compensation formula. In turn, this would give managers an incentive to vary the capital structure to maximize their compensation. This balance sheet rearrangement might well be inefficient and would not necessarily reduce systemic risk. Indeed, the shareholders' governance power (especially as exercised by blockholders) might well encourage management to engage in this sort of regulatory arbitrage. Among other things, this approach would provide an impetus for financial innovation to create new instruments that would have particular weight in the regulators' formula. The effort to specify what "counts" in the managers' maximand sounds hauntingly similar to the regulatory rules that encouraged firms to carry triple-A rated structured finance products or that permitted lower capital charges for assets that were insured or guaranteed by purportedly triple-A rated counterparties.

Second, the valuation issues of "enterprise value" are non-trivial. Many liabilities do not trade in thick markets. In the case of bank finance, they may not trade at all. Although credit default swaps may provide some useful information, CDS trading markets are often thin and do not necessarily cover the full range of bank liabilities. Thus the availability of reliable valuation information will vary across firms and over time. There could well be pressure for firms to standardize liability forms to promote valuation transparency, or to look to a particular subset of standardized liabilities to proxy for the firm's liabilities valuation. This creates incentives to distort capital structure for a favorable valuation result. Such an approach also increases the pressure on the "mark to market" debate over financial firm balance sheets, which thus far has focused on the asset side. If liability side valuations affect managerial compensation, elaborate accounting rules will follow.

Third, even a technically tractable, minimally game-able compensation formula that includes credit claims rests on a contestable assumption: that creditors would expect to bear significant losses in the failure of a financial firm and that enterprise value would therefore be an effective instrument to change managerial conduct. As an empirical matter, the pre-Lehman risk of significant losses for creditors of large financial firms was not high. Indeed, the government actions to address the financial crisis are notable for the losses not imposed on creditors.¹⁵ The current financial regulation reform legislation tries to bring this "too big to fail" problem under control with a new style resolution procedure for failing financial firms. In the wake of the financial system freeze-up following the Lehman bankruptcy filing, which did indeed result in significant creditor losses, the credibility, even wisdom, of such a strategy is open for debate.¹⁶

C. An Alternative Proposal: Convertible Equity-Based Compensation

¹⁵ The exception was in the case of Washington Mutual, in which the purchase and assumption arranged by FDIC did not protect all non-insured creditors.

¹⁶ See generally Jeffrey N. Gordon and Christopher A. Muller, Facing Financial Crisis: The Case for a Systemic Emergency Insurance Fund, forthcoming, 11 Yale J. Reg. (winter 2011).

The value of the Bebchuk-Spamann analysis is to remind us that the systemic risk associated with financial firm failure requires us to think differently about executive compensation in such firms. In particular we need to cabin risk-taking by managers that may enhance shareholder value only if systemic distress costs are not considered. The design problem is how to make managers “see” those costs yet not erase the traditional managerial obligation to shareholders; that is, to encourage “optimal” risk-taking, not “excessive” risk-taking. The goal is a compensation mechanism that cuts off that part of the risk-incenting distribution in which such incentives may have significant social costs because of the potential for systemic distress should the risks turn out badly.¹⁷

Here is a different approach to that problem: convertible equity-based pay. Specifically, senior executives at financial firms should receive a significant portion of stock-related compensation in the form of equity that will convert into subordinated debt upon certain external triggering events, such as a downgrade by the regulators to a “high risk category,” a specific deterioration in the firm’s book-to-equity ratio (or some other critical ratio), or perhaps a stock price drop of a specified percentage over a limited time period. The equity will convert into subordinated debt based on the value of the converted equity as of a period prior to the conversion moment, less a significant haircut. This mechanism both imposes losses on senior management for deterioration in the firm’s financial condition while giving it a significant stake in avoiding further deterioration. The recent financial crisis provides a useful time series of stock price changes that could be mapped against other measures of financial distress at the firm level and the financial sector level so as to provide the appropriate trigger points, which should be set well in advance of financial firm insolvency. The recent period has also provided data to calibrate an appropriate conversion algorithm.¹⁸ The goal is to avoid the need to use resolution authority, which will could accelerate financial sector distress.¹⁹

¹⁷ See Sudhakar Balachndran, Bruce Kogut, and Hitesh Marnal, *The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008* (Col. Bus. School W.P., February 2010).

¹⁸ Convertible equity-based pay bears a family resemblance to “contingent convertible bonds” that have been proposed as a new element in financial firms’ capital structure. Among other features, “co-co’s” promote shareholder monitoring of managerial risk-taking by providing a credible threat of dilution in the event of financial distress, because of the automatic conversion of a significant amount of debt into equity. Assuming that anti-dilution protection is scrubbed out of managerial compensation contracts, the dilution threat from co-co’s should also directly affect management behavior. However, because co-co’s are addressed to the entire equity base, the extent of dilution, and thus the effect on managers, will be less than for convertible equity-based pay. As a practical matter, it may be easier to adopt an approach that is targeted only at managerial conduct rather than a new mandatory feature of the financial firm balance sheet that also aims to provide a guaranteed source of new equity to cover prior capital losses. Also, co-co’s do not address the perverse incentives of CEOs to resist equity raises, the Fuld problem.

¹⁹ See Gordon & Muller, *supra* note 16.

This approach has four particular advantages. First, it will give senior managers incentives to avoid risky strategies. The financial crisis demonstrated that stock prices of financial firms respond to the shareholders' perceptions of financial distress, not just because of the risk of the firm's insolvency but because of the more common dilution risk from additional equity issuances to stabilize the firm. Requiring managers to register an equity conversion plus haircut because of a stock price decline (or a regulators' downgrade) will create a manager-specific dilution risk that will change managerial behavior. Rather than alter the general managerial charge to act on behalf of shareholders or attempt to refigure a new maximand, enterprise value, this mechanism is tailored to give managers special incentives to avoid financial distress. In other words, the mechanism will curb "excessive" risk-taking from the social perspective but leave in place incentives for risk-taking that is closer to optimal.²⁰

Second, convertible equity-based pay avoids the Fuld problem. At the point at which the firm should be negotiating for new capital, indeed may come under regulatory pressure to raise new capital, the CEO's incentives switch dramatically from protecting the shareholder option into protecting the creditors and, by extension, avoiding a firm failure that can trigger systemic distress. Because the equity converts into subordinated debt, the senior management wealth tied up in the firm is now in the form of debt claims that are senior to shareholder claims. In other words, at an important moment in the evolution of firm-specific financial distress, management now has incentives to find additional capital to buoy up the firm. This of course will protect the creditors and dilute the shareholders, but this fits with the program of minimizing systemic distress.²¹

Convertible equity-based pay solves a shareholder commitment issue in addressing the Fuld problem. Ex ante, shareholders may agree about the importance of avoiding systemic distress. Nevertheless the shareholders of Lehman, particularly the large, undiversified shareholders may be rooting, ex post, for Fuld to play tough in negotiating for new capital or a sale. They may press Fuld to promote immediate shareholder interests, to enhance the value of their near-the-money (or out of the money) option. The convertible equity approach solves this

²⁰ This is not to say that convertible equity-based pay is a complete solution, even from a compensation perspective, for the problem of excessive risk-taking in a financial firm, which can manifest itself in a range before conversion becomes a serious threat and among employees (like traders) who are not senior managers. A variant of the proposal could possibly be employed for non-senior based managers.

²¹ As proposed, this convertible equity-based pay calls for a managerial haircut at the time of conversion, to avoid the anomaly of rewarding managers for decision-making that threatens the firm with an economic claim superior to shareholders. Yet the haircut should be relatively small to avoid incentive effects for extra risk-taking as the firm nears the conversion trigger point. Otherwise would be to undermine the objective of minimizing the risk of firm failure. Similarly, while it may be desirable to provide a reconversion option, from subordinated debt to stock-based instruments, as the firm moves beyond financial distress, the terms and timing of any such reconversion must be measured to avoid incentives for pre-mature risk-taking.

problem by locking in a reversal of managerial incentives for a financial firm nearing financial distress, to give Fuld a tangible reason to push back against such shareholders.

Third, another advantage is that convertible equity-based pay could be promoted and adopted as part of a corporate governance reform agenda. Even though shareholders, particularly large, undiversified shareholders, may not, *ex post*, favor conversion, they might well favor, *ex ante*, a strategy that provides managerial incentives to avoid financial distress. There are two sorts of reasons, firm specific and systemic. *Firm specific.* Because convertible equity-based pay will reduce the risk of the firm's failure, it should lower the cost of debt generally, which will redound to equity's benefit. Overcoming the Fuld problem will have particular benefits. Creditors who are entitled to make collateral calls to cover shortfalls from the possible decline in asset values or who can simply refuse to rollover their debt are more likely to forebear at crucial moments if they know that the CEO will not have the incentive to risk the firm's franchise value on a low-probability turnaround bet. After the conversion trigger, the CEO will be working for the creditors (or at least not against them), which will reduce the run risk. *Ex ante*, equity holders will share in the value of these benefits. Even undiversified shareholders gain from these firm-specific effects of convertible equity-based pay.

Systemic. As explained above, the standard incentive alignment story contemplates risk-neutral (because diversified) shareholder principals and naturally risk-averse managers who are compensated with stock-based compensation to change their risk preferences. It also rests on the assumption that systemic risk levels are not changed by the shareholder-manager contract. But the failure of a significant financial firm imposes costs on diversified shareholders because a breakout of systemic distress is likely to reduce overall portfolio values. Asset pricing models generally specify compensation for bearing systemic risk. Thus a compensation mechanism that can reduce systemic risk will inure to the diversified shareholder's benefit.

Conceivably convertible equity-based pay could be adopted via debt covenants, since creditors would also benefit from avoidance of the Fuld problem. This seems unlikely. In general management is eager to obtain "covenant lite" financing. Secured creditors of financial firms seem to focus more on collateral quality and priority. Thus governance reform seems a more promising private-ordering route.

Recent compensation changes promoted by governance activists have reflected concerns that certain managerial incentives are too high-powered and may distort management decisions toward excessive risk-taking. This has led to moves away from stock options, for example, in favor of restricted stock. The Council of Institutional Investors, which offers guidance to public pension funds and other institutional investors, warns against pay practices that leave managers "emboldened to take excessive risks to pump up short-term gains at the expense of long-term

value creation.”²² Indeed, a focus on “long term equity” is reflected in the new Risk Metrics Compensation Grid, which bases a third of company’s score based on the proper design of longterm incentive plans.²³ Convertible equity-based pay fits with this agenda.

New federal legislation offers a ready avenue for a governance campaign to adopt convertible equity-based pay. TARP recipients are already subject to a shareholder advisory vote on pay, so-called “Say on Pay.” The current financial regulatory reform legislation contains a similar provision for all public firms. It would be easy to promote convertible equity-based pay as part of the annual compensation review.

Fourth, a final advantage is that convertible equity-based pay would be a suitable measure for the Fed to promote or even mandate as part of its on-going “guidance” of large financial firm compensation practices.²⁴ The approach addresses the effect of compensation structures on risk-taking by financial firms, rather than trying to set compensation ceilings. Such a structural approach falls more readily in the Fed’s regulatory remit. Moreover, as noted approved, this particular mechanism does not require the Fed to devise a new objective function for the financial firm or to produce an elaborate regulatory guide to implementation of a new balance of interests between shareholder and creditor interests in the financial firm. Convertible equity-based pay is also consistent with regulatory strategies like “living wills” that force firms to devise mechanism of coping with the onset of financial distress. Of particular importance, a regulatory mandate would provide a benefit, not a cost, for a diversified shareholder. This result may not be achievable via private ordering because of the organizational advantages of potential blocking coalitions of management and large shareholders vs. diversified shareholders.

IV. Board of Directors Adoption of Convertible Equity-Based Pay as Solving a Fiduciary Duty Problem

The decisions of a systemically important financial firm on the edge of financial distress present distinct fiduciary duty challenges for the board of directors. In addition to the likely clash of interests between shareholders and creditors, there is a novel conflict between the interests of managerial shareholders and most public shareholders, who disproportionately face systemic risk. Convertible equity-based pay is an ex ante approach to resolving these issues.

²² Council of Institutional Investors, Top 10 Red Flag to Watch for When Casting an Advisory Vote on Executive Pay (March 2010) available at

<http://www.cii.org/UserFiles/file/resource%20center/publications/March%202010%20-%20Say%20on%20Pay%20Checklist.pdf>.

For a recent survey of calls for a long term focus in financial firm compensation, see Lucian Bebchuk & Jesse Fried, Paying for Long-Term Performance (forthcoming 2010 Univ. of Pennsylvania L. Rev 2010).

²³ See Adam O. Emmerich, Understanding RiskMetrics Compensation “GRId,” (June 1, 2010), available at <http://blogs.law.harvard.edu/corpgov/2010/06/01/understanding-riskmetrics-compensation-grid/>

²⁴ See Guidance on Sound Incentive Compensation Policies, Joint Release by the Dept. of the Treasury, the Federal Reserve System, and the FDIC, -- Fed. Reg. -- (June --, 2010).

Ever since Chancellor Allen's famous footnote in *Credit Lyonnais*,²⁵ the Delaware courts and boards of firms incorporated in Delaware have struggled with the question of the board's fiduciary duties to creditors as the firm approaches the "vicinity" or "zone" of insolvency. Should the board's customary duty to shareholders shift so as to require at least some concern for creditors, or should shareholder interests remain prior in the event of a conflict? The concern is particularly acute when pursuit of shareholder interests may result in negative net present value bets in which the upside goes to shareholders while most, if not all, of the downside, hits creditors. After some initial doctrinal uncertainty, Delaware corporate law attempts to mitigate this problem by permitting the board of a firm that is in the "zone of insolvency" to consider creditor interests not just shareholder interests. But the applicable legal doctrine functions as a "shield" against shareholder objection rather than a "sword" for creditor imperative.²⁶ Nevertheless, the creditors can bring a derivative claim for actions taken *after* the corporation becomes insolvent, for example, the negative present value bet that favors the shareholders over the interests of the corporation.²⁷

A systemically important financial firm in the zone of insolvency presents, however, an additional kind of fiduciary duty challenge for the board, because of the conflict between managerial shareholders and the typical public shareholders. In a capital raise or sale, a CEO's large equity ownership position can produce a conflict of interests with public shareholders akin to a management buy-out. Preservation of the CEO's upside may entail a high risk of systemic costs that are disproportionately borne by public shareholders. While public shareholders of course want to preserve their value in the firm, they have a much greater tolerance for dilution than the undiversified CEO.²⁸

Convertible equity-based pay offers the board an *ex ante* approach to dealing with difficult fiduciary issues arising from both the shareholder-creditor conflict and the management-shareholder conflict. Presumably the trigger for conversion of senior management's equity-based pay will be a deterioration of the firm's financial condition. At that moment, the firm is

²⁵ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, n. 55 (Del. Ch 1991). The footnote provided a hypothetical in which a highly levered firm faced a choice between (i) accepting a litigation settlement offer that would fully cover creditor claims but leave only a small amount for shareholders or (ii) defending on appeal a highly favorable verdict that if sustained would provide shareholders with a substantial recovery but if reversed could lead to the firm's insolvency. Given the odds on appeal, rejecting the settlement in favor of the appeal was a good bet for shareholders (since the creditors bore most of the downside risk) but a poor bet for creditors and a negative net present value bet when both equity and debt claims were aggregated.

²⁶ *Production Resources Group, L.L.C. v. NCT Group, Inc.* 863 A.2d 772 (Del. Ch 2004); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. Supr. 2007).

²⁷ *Id.* For a useful doctrinal summary, see Dianne F. Coffino and Charles H. Jeanfreau, *Delaware Hits the Brakes: The Effect of Gheewalla and Trenwick on Creditor Claims*, 17 Norton J. Bankruptcy Law & Prac. 63 (2008).

²⁸ This conflict would be important even for those who would minimize the significance of the shareholder/director conflict in the vicinity of insolvency. See, e.g., Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duty in the Vicinity of Insolvency*, 1 J. Bus. & Tech. L. 335 (2007).

presumably in the “region of insolvency” if not necessarily the “zone.” The conversion of equity into subordinated debt eliminates management’s incentives to pursue negative net present value bets. It consequently reduces the risk of creditor losses and of the failure of the firm that could produce systemic losses for shareholders. A board could find this ex ante approach particularly attractive because the alternative approach to navigating the management-shareholder conflict is to take over decision-making about capital raises and the sale of the firm as the firm runs into financial difficulty.²⁹

Conclusion

This essay has proposed a novel compensation mechanism for financial firms, convertible equity-based pay. The goal is to reduce managerial incentives for excessive risk taking – that is, risk-taking that is disproportionate to the social risk of systemic distress. It does this by forcing a mandatory conversion of senior managers’ equity into subordinated debt on valuation basis that imposes an immediate loss but that also preserves incentives to prevent further deterioration of the firm. In particular this mechanism avoids the “Fuld problem” of a CEO whose large equity stake might deter him or her from pursuing a dilutive capital infusion or sale that would reduce the chance of the firm’s failure. From the perspective of diversified shareholders in a financial firm, this compensation mechanism will improve their overall wealth, because it reduces the risk of systemic distress that will increase the systemic risk premium and thus reduce portfolio values overall. Because of the improvement in diversified shareholder welfare, convertible equity-based pay could be pursued by private corporate governance activism. It would also be useful approach for the Fed’s regulation of executive compensation in systemically important financial firms.

²⁹ One potential objection is that the board’s shareholder focus is generally limited to interests in respect of the particular firm, not “systemic” interests that arise because of share ownership in other firms. One answer, of course, is that the governance of systemically important financial firms is different, and concern for the Fuld problem is one example. In the typical firm, non-shareholder interests can be reasonably well protected through contract and tort; not so for the systemically important firm. Moreover, the usual reason for the board’s own-firm focus is that shareholder interests outside the firm are so diverse that the only point of shareholder agreement is to maximize share value of the particular firm. This is not the case for diversified shareholders of a systemically important firm, all of whom face systemic risk if the firm fails.

A narrower reason for the board’s concern about the Fuld problem is that a board needs to attend to a conflict of interest between the CEO and other shareholders whatever the source. For example, in the case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the Court regarded the CEO’s desire to retire as undermining the board’s entitlement to rely on his judgment about a cash offer for the firm. Both the CEO and the other shareholders wanted to “maximize shareholder value” but the CEO’s desire for a near-term exit strategy presented a clear conflict with the interests of other shareholders without pressing short term objectives. This conflict required the board to intervene on their behalf. The Fuld problem presents another instance of a clear conflict requiring board intervention to protect non-managerial shareholders.

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