Wall Street's Corporate Governance Crisis

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The board of directors of a public company[1] is only responsible for a relatively few of the almost infinite number of decisions that are made at a public company over any period of time. Yet, when a corporate board does make a decision, for example, the appointment of a chief executive officer (CEO) or the approval and recommendation to shareholders of a merger agreement, the decision can have a major impact on the firm. Now, based on the fallout from the financial crisis of 2008, we can add corporate board approval of company-wide compensation policies to the list of board decisions that are of potentially major significance to the firm, at least for those public companies such as "Wall Street" firms (financial institutions with large financial trading and investment banking operations whether or not they are based in proximity to lower Manhattan) that compensate their employees with large annual bonuses.

The significance of these employment policy decisions cannot be overstated. By comparison, what was at stake in the much publicized litigation involving the Walt Disney Company was almost trivial, since the facts of the *Disney* litigation did not involve a threat to the company's existence or billions of dollars of capital outflows.[2]

The elevation of company-wide compensation policies to the fore of corporate governance issues facing Wall Street firms requires both a change in perspective on how these policies should be implemented as well as a reconsideration of whether the protections of the business judgment rule (BJR) as applied to corporate board decisions under corporate law need to be adjusted accordingly.

The Genesis of the Problem

Historically, Wall Street firms have compensated a significant number of employees with large annual bonuses, presumably to retain employees who are perceived by the boards of these firms to create what is commonly referred to as "alpha," the excess returns earned above what the market will offer to the passive investor for the risk taken. For example, in 2007, employees at Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns were paid in total a record $39 billion in bonuses,[3] up from $36 billion in 2006.[4] If only these companies had retained the bulk of these large bonuses over the last two years when the mortgage markets were noticeably tanking, perhaps the magnitude of the financial crisis would have been significantly less.

Such compensation policies may have been appropriate at a time when investment banks and financial trading operations were privately held and operated as partnerships, but as public companies, these policies cannot be allowed to reappear when the turbulent times on Wall Street come to an end or else our current history will eventually repeat itself. Compensation structures that reward managers and traders with huge annual bonuses encourage the pursuit of what Professor Raghuram Rajan of the University of Chicago Business School refers to as "fake alpha" (appearing to create excess returns but in fact taking on hidden tail risks, which produce a steady positive return most of the time as compensation for a rare, very negative, return).[5] In essence, the pursuers of fake alpha trade tail risk for cash, and hopes that things don't blow up until after huge bonuses have been paid out for a number of years.

By investing in fake alpha, the firm is not earning excess returns above what the market will offer for the risk taken, only normal returns with an unusual risk-return profile. The result is a misleading appearance of profitability and leads to an under-capitalized institution if compensation policies are not adjusted accordingly. Unadjusted compensation polices treat the annual returns earned for pursuing fake alpha as essentially risk-free when compensating managers and traders, while the risks of loss are shifted to those who hold other interests in the company (such as shareholders and ordinary employees, and now the US taxpayers) even though the costs of risk-taking may not be

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felt by these stakeholders for a number of years. Unfortunately, pay up time has now arrived and it is clear that the large bonuses given out in 2006 and 2007, if not also in prior years, were not warranted and contributed significantly to the ongoing financial crisis.

Adjusting Compensation Policies with Clawbacks

Board approval of compensation policies that encourages the pursuit of fake alpha can be discouraged by the use of "clawbacks," provisions in bonus plans that would require the recipient to return all or part of the bonus if certain subsequent negative events occur, such as poor financial performance. This approach was broadly endorsed in the recently enacted Emergency Economic Stabilization Act of 2008, the $700 billion bailout of financial institutions who overinvested in excessively risky mortgage assets.

The use of clawbacks is not a new concept—according to a recent Corporate Library survey of approximately 2,100 companies, nearly 300 companies had clawback provisions.[6] This compared to only 14 companies only four years ago. Moreover, Section 304 of the Sarbanes-Oxley Act, which only applies to the CEO and the CFO, generally requires these executive officers to disgorge bonuses and other incentive based compensation within a twelve month period after the release of a restatement or material non-compliance due to misconduct. For example, UnitedHealth Group recently recouped more than $450 million in compensation from its CEO, Dr. William McGuire, as a result of a stock options backdating scandal that was disclosed in 2006.

Clawback provisions at the corporate level can be implemented in numerous ways: through formalized policies, through the compensation plan itself or through employment agreements. However, while these provisions have broad appeal given their function, they do have issues that need to be dealt with. For example, boards have to decide to whom the provisions apply and then to which specific incentive awards. Of even more importance, under what circumstances would the clawback provisions be triggered and how many years back should the provisions apply. Despite the need for these difficult determinations, we expect to see an increased use of clawbacks as a means to control excessive risk in compensation policies.

Fake Alpha and the BJR

Under Delaware corporate law, the BJR protects directors from financial liability for the decisions they make as a board as long as the decisions were made on *an informed basis*, in *good faith* and in the honest belief that the action taken was in the *best interests* of the company.[7] In a timely paper posted on the Social Science Research Network by David Rosenberg, *Supplying the Adverb: Corporate Risk-Taking and the Business Judgment Rule*,[8] Professor Rosenberg argues that it is now time to revisit the issue of whether the business judgment rule should continue to protect the decisions made by the board of directors when those decisions are knowingly tainted with *excessive* risk. He finds that such decisions should be considered a breach of good faith and therefore should not receive the protections of the BJR.

However, the pursuit of fake alpha does not, by itself, imply a breach of good faith. While the pursuit of fake alpha may be economically inefficient, as the trade-off is the pursuit of real alpha, its pursuit is not necessarily tainted with excessive risk. The millions of investment opportunities public companies pursue each year have a rainbow of risk-return profiles, pursuing fake alpha as defined above has just one of those profiles. Therefore, in the context of the BJR, the knowing pursuit of fake alpha is not the issue.

Good Faith and the Board's Risk Management Duties

But what is tainted with excessive risk is when a corporate board abdicates its role as the ultimate risk manager of the firm by approving the pay out of billions of dollars in discretionary bonuses without proactively considering whether the money may be necessary to maintain the company's financial health or provide for its survival. Such an abdication of board duties is when excessive risk-taking occurs in the board room, jeopardizing the long-term viability of the firm and thus should be considered under corporate law a breach of good faith and not deserving of

the protections of the BJR. Moreover, this can occur when pursuing real or fake alpha as risk is involved in both pursuits.

In a recent Delaware Chancery Court opinion, *Ryan v. Lyondell Chemical Company* (Del. Ch., July 29, 2008), the court made clear, as it originally did in the famous *Caremark* opinion[9] authored by former Chancellor William T. Allen, that it will not tolerate a corporate board that abdicates its duties.[10] In *Lyondell*, the court denied a motion for summary judgment because the record did not show any evidence that the board attempted to adequately perform its *Revlon* duties.[11] We should not expect any less from the Delaware courts when it reviews the record to see if a board had fulfilled its duties as the ultimate risk manager of the firm.[12]

The BJR is structured to protect corporate risk-taking and no one can really argue with Chancellor Allen when he stated in *Gagliardi v. TriFoods Intern., Inc.* that "[s]hareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital."[13] In proposing this very limited weakening of the BJR, it is not our intent to cool a company's rational pursuit of the "highest risk adjusted returns" it can potentially earn. We are only proposing that the law recognize a breach of good faith when a board abdicates its risk management duties by not proactively considering the effects on the firm's financial health and possibly its survival at the time it decides to pay out huge sums of money to specific stakeholders.

The importance of recognizing this breach of good faith is not in prosecuting a board that commits this breach, but in the deterrent effect that this will have on a board considering huge payouts that may put the firm at risk. Before doing so, a board will have to think twice or else face the possibly of financial liability or the embarrassment of a suit seeking injunctive relief for its decision.

Conclusion

Compensation plans and the law evolve as we learn from experience. Unfortunately, the financial crisis of 2008 has been a hard way to learn. In order to discourage the pursuit of false alpha, we advocate the use of clawbacks to mitigate the effect of excessive compensation plans. In order to deter boards from abdicating their risk management duties, we advocate a slight expansion in our understanding of when a breach of good faith occurs so that the BJR cannot protect excessively risky compensation decisions.

Notes

1. The publicly held firm is an "economic organization[ ] in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted." Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 n.9 (1992).

2. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006). In *Disney*, the Disney board approved an employment agreement with Michael Ovitz (President of Disney) which provided him with an unusually large severance payout if he were to be terminated without cause soon after commencing employment. Fourteen months after becoming employed, Ovitz was terminated without cause, leaving the company with a severance payout of approximately $130 million. While an extremely large cash outflow for any company, it did not significantly affect the financial health of Disney.

3. Tom Randall and Jamie McGee, *Wall Street Executives Made $3 Billion Before Crisis* (Update1; September 26, 2008), available at *http://www.bloomberg.com/apps/news?pid=20601109&sid=aGL5l6xOPEHc&refer=exclusive.*

4. Christine Harper, *Wall Street Bonuses Hit Record $39 Billion for 2007* (Update3; January 17, 2008), available at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHPBhz66H9eo.*

5. Raghuram Rajan, *Bankers' pay is deeply flawed*, Financial Times FT.com (January 9 2008), available at *http://www.ft.com/cms/s/18895dea-be06-11dc-8bc9-000779fd2ac,dwp_uuid=73adc504-2...*

6. Alan Rappeport, *Clawbacks Claw Their Way into Corporate Strategy, More companies are adopting provisions to recoup cash from executives involved in malfeasance*, CFO.com (June 4, 2008) available at *http://www.cfo.com/article.cfm/11488592?f=related.*

7. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted) (emphasis added).

8. David Rosenberg, *Supplying the Adverb: Corporate Risk-Taking and the Business Judgment Rule* (September 11, 2008) available at *http://ssrn.com/abstract=1266723.*

9. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996) (a board cannot abdicate its duty to monitor for legal compliance).,

10. For a number of excellent posts on *Lyondell*, *see* Francis G.X. Pileggi's Delaware Corporate and Commercial Litigation blog, available at *http://www.ideoblog.org/*.

11. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

12. Of course, one way the board can demonstrate that it has not abdicated its risk management duties is to implement a firm-wide clawback policy as described above.

13. Gagliardi v. Trifoods International, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).