CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION IN FINANCIAL FIRMS: THE CASE FOR CONVERTIBLE EQUITY-BASED PAY

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Unlike the failure of a nonfinancial firm, the failure of a systemically important financial firm will reduce the value of a diversified shareholder portfolio because of economy-wide reductions in expected returns and a consequent increase in systematic 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 nonfinancial firms will not fit financial firms. Regulations that limit 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 a 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 resulting 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, this paper proposes a new compensation mechanism for senior managers: convertible equity-based pay. Upon certain external triggers—for example, a regulatory downgrade into a high-risk category, deterioration

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in a key financial ratio, or a significant stock price drop—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.

I. INTRODUCTION

The financial crisis of 2007–09 raises the question of whether the traditional tools of corporate governance are adequate to address the 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

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."[2] 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 Article 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 rather the intellectual failure to appreciate the gap between shareholder and managerial interests, which is unusually wide for systemically significant financial firms. Thus, there is a "business case" for corporate governance activism by the diversified shareholders who are the majoritarian owners 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 both within and across

[1] *See* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes*, 46 HARV. J. ON LEGIS. 323, 365 (2009); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 248 (2010).

[2] "Too big to fail" refers to financial firms that would be rescued by the government rather than being allowed to fail, because the financial claims on their balance sheet are so large relative to the financial sector that failure would have large negative effects on other financial firms and ultimately, large negative effects on the real economy. Ex ante, the optimal policy is for government to pledge "toughness"—to permit failure —to control excessive risk-taking; but ex post, in the face of the systemic distress costs of the failure of a "too big to fail" financial firm, the government should relent.

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 a sale of the firm that would substantially dilute their equity positions. This might be called the "Fuld problem." Contrary to 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.[3] Rather, the critical point from the perspective of systemic risk mitigation was that as 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 a large equity stake would face a much greater proportionate wealth loss than a diversified shareholder from a dilutive capital raise or sale, while 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 Article 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

[3] *See generally* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257 (2010).

the firm's financial situation becomes more precarious. It solves the "Fuld problem." Both of these changes in managerial incentives should reduce systemic risk.

Finally, this Article explains why boards of directors 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 are presumptively diversified, the board needs to intervene for similar reasons that call for 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.

II. CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION AT FINANCIAL FIRMS

A. Financial Firm Shareholders and Systemic Risk

The claim that shareholders would a priori have insufficient incentives to constrain "excessive" managerial risk-taking in the financial firm rests on a model of shareholder-manager interaction in the nonfinancial firm that does not fit financial firms. The standard account contemplates an incentive mismatch between risk-neutral (because diversified) shareholder principals and risk-averse managers. Thus the challenge for shareholders is to encourage managers to take all positive net present value investment opportunities despite the possibility that such risk-taking may occasionally turn out very badly, leading to insolvency or restructuring, and the consequent destruction of the managers' firm-specific human capital investment. The common solution to this problem is equity-based pay,

which puts the managers in the shareholders' shoes.[4] 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." In other words, the effects of the failure will be "idiosyncratic," not "systematic." Thus, if all firms are taking good bets, then on average the diversified investor will be better off. This is not the case when a systemically significant financial firm fails. As demonstrated by the failure of Lehman Brothers in September 2008, such a failure has powerful *systematic* effects. The failure of one financial firm will damage its competitors in the financial sector and, because of the importance of the financial sector to the real economy, may cause widespread damage to nonfinancial firms as well. In short, 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 systematic risk (and perhaps other sorts of risk). The standard model assumes that the level of systematic risk is not affected by the failure of any particular firm. This is not the case for systemically important financial firms. The failure of one such firm will increase the likelihood that other financial firms will fail due to contagion or commonality.[5] This will in

[4] This is not necessarily optimal from the creditors' point of view, since creditors internalize some of the risk of business failure. But the standard model assumes that creditors will generally adjust via compensatory interest rates or protective covenants. Note that this account of stock-based compensation also implies an optimal level of managerial diversification away from own-firm stock. A manager whose entire net worth and human capital is linked to a single firm may be even more risk-averse, which will undermine risk-taking incentives.

[5] "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 and 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 other firms

turn lower the expected profitability of many nonfinancial firms via knock-on effects from contraction in the financial sector. This contraction will reduce the availability of credit and raise its cost. The failure of a systemically important firm adds a new sort of risk to the economy. In short, the failure of a systemically important financial firm can reset systematic risk levels, increase the systematic risk-bearing premium, and in turn generate value reductions across a diversified portfolio.[6] Thus the systemic distress costs for diversified investors are twofold: first, a reduction in expected returns across the economy; second, an increase in the systematic risk premium. Both will reduce the value of a diversified portfolio.

This is a point with far-reaching implications. Managers who have large equity positions in their firms are in a substantially different position from diversified public shareholders. Such managers do not internalize sufficiently the consequences of systemic distress because their financial and human capital investments may be undiversified. Indeed, a major thrust of recent compensation reform has been to increase managerial "skin in the game," and in particular to increase sensitivity of managerial wealth to the firm's performance. As the financial firm heads for trouble, this opens a gap between managers, who do not internalize the full consequences of the firm's failure, and diversified shareholders, who do.[7]

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: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 160 (2011).

[6] A more formal way to make the point is to say that the level of systematic risk is affected by the existence of systemically important firms in the economy and the probability of their failure. By revealing information about the probability distribution, the actual failure of any such firm immediately increases the systematic risk discount.

[7] Another way to frame the point is to say that economic losses of diversified shareholders of a systemically important financial firm are not

This analysis points to two areas of incentive incompatibility: first, the general risk profile of financial firms; second, decision making when the firm faces financial distress. The "wedge" in the design of optimal compensation is not between managers-and-shareholders and society, but between managers and shareholders-and-society.

Now to reframe the point in governance terms: the standard model of executive compensation drawn from nonfinancial firms is that systematic risk levels are not changed by terms of the shareholder-manager contract. This follows from the observation above that systematic risk levels are not affected by individual firm failure. Thus assuming all actions are positive net present value bets, "excessive" managerial risk-taking is not a coherent idea for the nonfinancial firm. But that conclusion does not follow for a systemically significant financial firm, *even from the shareholder point of view*. Thus a compensation mechanism that reduces the probability of the failure of a systemically important financial firm may 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

capped by limited liability when the firm fails, whereas undiversified managerial shareholder losses are capped to a much greater extent. In ordinary times, it might be thought that managers' large firm-specific human and financial capital investments hold down excessive risk-taking, but outside investments in cash and non-risky assets may provide "wealth insurance." As the firm nears financial distress, the value of firm-specific managerial investments declines, and as holders of near-the-money options, managers' incentives shift accordingly.

beyond portfolio losses, for example, the human costs of higher unemployment), their internalized losses are sufficient to justify appropriate measures to control financial firm risk-taking. Regulation is necessary to curb excessive risk-taking by management in systemically important financial firms because of the limits of collective shareholder action, especially by diversified shareholders, not because shareholder incentives are generally misguided.[8] On this view, the regulator provides the necessary coordination to obtain shareholder objectives. Well-crafted regulatory intervention in this realm is a benefit to diversified shareholders, not a cost. The potential benefits of regulation are two-sided. Regulation that reduces the failure risks of systemically important firms not only protects against a

[8] 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. However, the diversified shareholder would benefit from risk-avoiding regulatory restrictions on executive compensation that avoid a scenario testing the credibility (and wisdom) of the "no bailouts" posture where the stakes are a major outbreak of systemic distress.

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 outbreaks of systemic distress, which are highly salient for a while and then recede. Regulators too will suffer from myopia. But regulation can embed systemic risk-internalization awareness; "lessons learned" become 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 functionally similar non-banks arising from the liquidity mismatch between assets and liabilities. Runs can occur even where risk-taking is not "excessive," meaning that a run can arise apart from the mismatch between private gains and social losses. This fragility is mitigated by deposit insurance, and safety and soundness regulation.

collapse in portfolio values, but also—as a result of systematic risk reduction—may increase portfolio values.

The limits to effective shareholder action to control risk-taking in financial firms are a mix of well-known limits to shareholder power and some particular applications to financial firms. 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 legislation now requires an advisory shareholder vote on pay-setting ("Say on Pay");[9] this can be leveraged by the threat of a "withhold vote" campaign against targeted directors to provide a new route for shareholder initiative on compensation practices.[10] The long-run impact of these governance opportunities remains unclear.

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[9] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78n-1 (2012) [hereinafter Dodd-Frank Act] (adding Section 14A to the 1934 Securities Exchange Act); *see also* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Exchange Act Release No. 63,768, 100 SEC Docket 868 (Jan. 25, 2011) (SEC implementation rules for Section 14A). The Act also eliminated broker discretionary voting on executive compensation. *See* 15 U.S.C. § 78f(b) (2012) (amending Section 6(b) of the 1934 Securities Exchange Act). This has now been implemented by SEC approval of amendments to NYSE Rule 452 and NASDAQ Rule 2251, which deem executive compensation matters to be "non-routine," meaning that brokers cannot vote shares registered in "street name" without instructions from the beneficial owner. *See* Order Approving NYSE Proposed Rule Change Relating to Broker Discretionary Voting, Exchange Act Release No. 62,874, 99 SEC Docket 946 (Sept. 9, 2010); Order Approving NASDAQ Proposed Rule Change Relating to Voting by Non-Beneficial Owners, Exchange Act Release No. 62,992, 99 SEC Docket 1528 (Sept. 24, 2010).

[10] *See* David Katz, *Focus in 2011 Will Remain on Executive Compensation*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Jan. 16, 2011, 9:23 AM), http://blogs.law.harvard.edu/corpgov/2011/01/16/focus-in-2011-will-remain-on-executive-compensation/#4b.

Second, of particular importance, institutional actors' use of governance power in financial firms to protect diversified shareholder interests will be constrained by what Ronald Gilson and I have called the "agency costs of agency capitalism."[11] Although the beneficial owners of institutional claims are generally diversified, the self-interest of the investment managers will limit the institutions' firm-specific governance interventions on behalf of diversified shareholder interests. The institutions' investment managers are judged by whether they can deliver "superior" performance, generally measured over a relatively short time frame. This performance is typically measured against a benchmark, so that the manager's focus is not the market's performance but his or her portfolio's performance relative to the benchmark. A manager overweight in a financial firm's stock wants it to outperform, irrespective of the fact that the greater risk-taking commonly associated with such outperformance may have systemic implications. Even if the manager foresees that such risk-taking by a firm or group of firms may have systemic effects, the incentive structure pushes the manager to assemble a portfolio that will be less severely impacted by financial distress rather than incur the uncompensated costs of a corrective governance intervention. Managers who are underweight in stocks particularly hard hit by systemic distress and overweight in the relatively well-insulated stocks will "outperform," even if their portfolios significantly decline.

Third, 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 probably under-diversified.[12] The deviation from diversification probably

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[11] *See generally* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. (forthcoming May 2013).

[12] Even one-percent ownership of a relatively small financial firm like Lehman Brothers, worth $47 billion at its peak, would challenge the

correlates with the increase in the percentage of ownership. Such a shareholder will internalize a smaller share of systemic risk distress cost relative to specific firm risk.[13] 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" versus "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 reintroduces 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 has 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, have disproportionate influence because their highly salient activism may threaten managerial reputation and careers. For nonfinancial firms this is not a problem as long as managers are pushed to pursue positive net present value projects.[14] It can be a big

diversification strategy of all but the largest investors. This is not to say that such an investor will have no other investments, but that such an investor is likely to be significantly under-diversified.

[13] 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 risk to systemic risk.

[14] 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* Jeffrey N. Gordon, *Shareholder Initiative*, 60 U. CIN. L. REV. 347, 368–70 (1991); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 NYU L. REV. 761, 833

problem in a systemically significant financial firm if influential shareholders do not adequately internalize systemic risk distress costs. 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 lead to excessive risk-taking. This is borne out by post-financial crisis empirical work that suggests that firms with a higher level of institutional ownership,[15] and in particular, firms with a higher level of "short-termist" institutional ownership, created executive compensation packages that produced such risk-taking.[16]

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 divergence between the interests of an organized minority and those of a relatively disorganized majority can produce a welfare-reducing outcome is a well-understood result in the political realm. The differential internalization of systemic risk distress costs brings this problem directly into the governance of the financial firm as well.[17] This opens a

n.199 (1985); Mark A. Satterwaite, *On the Scope of the Stockholder Unanimity Theorems*, 22 INT'L ECON. REV. 119 (1981).

[15] *See* David H. Erkens et al., *Corporate Governance in the 2007–n08 Financial Crisis: Evidence from Financial Institutions Worldwide*, 18 J. CORP. FIN. 389 (2012).

[16] *See* Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking* (Nat'l Bureau of Econ. Research, Working Paper No. 16176, 2011), *available at* http://ssrn.com/abstract=1502762.

[17] Conceivably, there is significant differential internalization of systemic risk by diversified shareholders versus blockholders even for nonfinancial 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 if disseminated widely, will have systematic effects (e.g., greater

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—rather than reflect a shortfall in—the influence of large, undiversified shareholders. The case for regulation is strengthened by the realization that many such blockholders are investment intermediaries acting for diversified investors and thus disserve the interests of their beneficial owners by promoting excessive risk-taking by financial firms.[18]

But regulation is necessary not only because of the diversity of shareholders within firms, but also because of shareholder diversity across firms. Blockholder-dominated firms are likely to engage in greater risk-taking than other firms. This increases the risk of own-firm failure, which could impose systemic distress costs on diversified shareholders (and others). But the higher (apparent) 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 without a dominant blockholder. This pattern also increases the likelihood of systemic distress.

The distinctive political economy of financial firm share-ownership 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 to invest greater resources into shaping the regulatory outcome, as noted above. One cautionary note for regulators: watch carefully which shareholders you pay attention to.

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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.

[18] *See* Gilson & Gordon, *supra* note 11.

III. 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 distress 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, who is reluctant to negotiate a large equity raise (or sell the firm) because the terms would massively dilute his personal equity stake, may instead calculate that holding out for a fortuitous turn in markets or regulatory forbearance has a higher expected payoff for him.[19] When expected creditor losses are taken into account, this is a negative net present value strategy that replays the familiar debt-equity agency problem.[20] When systemic distress costs are taken on board, the impact of this incentive mismatch is highly consequential.

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[19] 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 also could have been labeled the "Cayne problem," since there are published claims that Jimmy Cayne did not pursue opportunities to raise capital or sell Bear Stearns. There is ample evidence that parties believe the CEO responds to such incentives. The change-in-control provisions of golden parachutes, which contemplate, among other things, the payment of three times 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.

[20] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334–43 (1976).

The incentive mismatch is even more acute if the CEO has private information indicating 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 an equity raise or a 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.[21]

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

[21] The analysis also assumes that the board will be unable to monitor adequately the CEO's pursuit of (or rejection of) potential capital raises or sales of the firm. This seems reasonable in light of the board's common role of reviewing, rather than initiating, major transactions that have been identified and negotiated by the management team. Moreover, the board—which may own shares and be influenced by blockholders—may share the CEO's sympathies. The analysis also assumes that the wealth and power of a large equity position will overcome the CEO's reputational concerns about risking the failure of the firm to avoid a serious dilution. The point is not to assume a particular weighing of economic versus reputational losses, but to observe a powerful temptation.

least his financial stake would not have been in opposition to his reputational stake.

IV. A NEW COMPENSATION MECHANISM: CONVERTIBLE EQUITY-BASED PAY

The Article 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. Part IV 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.

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.[22] 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 distress costs are socialized. The shift into restricted stock (versus stock options) or the requirement of long-term holding periods affects this systemic risk mismatch only at the margin.

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[22] *Cf.* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653 (1998) (debunking the view that prior to the 1990s deluge of stock-related compensation, CEOs were paid like "bureaucrats"—receiving fixed compensation that was not responsive to firm performance).

Ironically, longer holding periods may exacerbate the Fuld problem.[23]

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 Stearns was not a particularly large firm—such a rule would dramatically reduce financial incentives throughout the 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.[24] 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). Bebchuk and Spamann,

[23] If the CEO were unable to take out *any* substantial wealth from the firm, this could reduce risk-taking in ongoing operations and possibly at the recapitalization moment. This would require that a CEO be unable to diversify from own-firm risk and systemic distress risk through conversion of stock to cash or other risk-free assets (that is, unable to purchase "wealth insurance"). *See id.* at 657. Such a strategy would encourage sub-optimally high CEO turnover, as presumably retirement would enable unfettered access to own-firm stock.

[24] *See generally* Bebchuk & Spamann, *supra* note 1.

however, 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 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' maxim sounds hauntingly similar to the regulatory rules that encouraged firms to carry triple-A rated structured finance products,[25] or that permitted lower capital charges for assets that were insured, or guaranteed, by purportedly triple-A rated counterparties.[26]

Second, the valuation issues of "enterprise value" are nontrivial. 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 as a proxy for the firm's liabilities

[25] Residential Mortgage-Backed Securities that were rated AAA carried a 20% charge in the calculation of risk-weighted assets, whereas residential mortgages held directly required a 50% charge ("qualifying") or 100% charge ("non-qualifying"). *See* MICHAEL CROUHY ET AL., THE ESSENTIALS OF RISK MANAGEMENT (2006); 12 C.F.R. § 567.6 (2010).

[26] *See* CROUHY ET AL., *supra* note 25; § 567.6(a)(1)(ii)(H)(1).

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.[27] The current financial regulation reform legislation tries to bring this "too big to fail" problem under control with a new style of resolution procedures for failing financial firms.[28] 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.[29]

C. An Alternative Proposal: Convertible Equity-Based Compensation

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

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[27] The exception was in the case of Washington Mutual. There, the FDIC did not protect all non-insured creditors with its purchase and assumption method of bank resolution.

[28] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5381–94 (2010) (comprising Title II, Orderly Liquidation Authority of the Dodd-Frank Act).

[29] *See generally* Gordon & Muller, *supra* note 5.

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 the part of the risk-incentivizing distribution in which customary incentives may have significant social costs, because of the potential for systemic distress should the risks turn out badly.[30]

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 also 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 both 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.[31] The goal is

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[30] *See generally* Sudhakar Balachandran, Bruce Kogut & Hitesh Harnal, *The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008* (Columbia Bus. Sch. Research Paper, 2010), *available at* http://ssrn.com/abstract=1914542.

[31] Convertible equity-based pay bears a family resemblance to "contingent convertible bonds" that have been proposed as a new element

to avoid the need to use resolution authority, which could accelerate financial sector distress.[32]

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 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 regulator's downgrade) will create a manager-specific dilution risk that

in financial firms' capital structure. Among other features, so-called "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 at only managerial conduct rather than an approach that is 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, known as the "Fuld problem."

[32] *See* Gordon & Muller, *supra* note 5, at 180. The design problem is similar to the challenge in fashioning an effective contingent capital instrument, which contemplates conversion of debt to equity at critical points in the evolution of financial distress so as to avert the failure of a systemically important financial firm. One such proposal seeks to provide "strong incentives for the prompt recapitalization of banks after significant losses of equity but before the bank has run out of options to access the equity market." Richard J. Herring & Charles W. Calomiris, *Why and How to Design a Contingent Convertible Debt Requirement* 1 (Apr. 19, 2011) (unpublished manuscript), *available at* www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/5631/contingent_convertible_debt.pdf. Convertible equity-based pay is in the spirit of such proposals. The compensation conversion mechanism is designed to produce incentives for a recapitalization before the onset of severe financial distress, operating directly through the managerial incentives channel.

will change managerial behavior. Rather than alter the general managerial charge to act on behalf of shareholders or attempt to refigure a new maxim and 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 are closer to optimal.[33]

Second, convertible equity-based pay avoids the Fuld problem. At the point at which the firm should be negotiating for new capital, indeed, may even come under regulatory pressure to raise new capital, the CEO's incentives switch dramatically from protecting the shareholder option to protecting the creditors. By extension, this will include avoiding a firm failure that could trigger systemic distress. Because the equity converts into subordinated debt, the senior management wealth tied up in the firm becomes a debt claim that is senior to shareholder claims. In other words, at this important moment in the evolution of firm-specific financial distress, management now has incentives to find additional capital to buoy the firm. This of course will protect the creditors and dilute the shareholders, but it fits with the program of minimizing systemic distress.[34]

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[33] 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, and among employees (like traders) who are not senior managers, before conversion becomes a serious threat. A variant of the proposal could possibly be employed for non-senior managers.

[34] 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, it would 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

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 ones—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 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 from short-term creditors. Ex ante, equity holders will share in the value of these benefits. Even undiversified shareholders

incentives for premature risk-taking after the injection of new equity, and to assure that the level of the capital raise will meaningfully reduce the riskiness of the firm.

gain from these firm-specific effects of convertible equity-based pay.

Systemic. As explained above, the standard incentive alignment story contemplates risk-neutral shareholder principals (as a result of diversification) and naturally risk-averse managers who are compensated with stock-based compensation to change their risk preferences. It also rests on the assumption that systematic 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 will likely reduce overall portfolio values, that is, will have a systematic effect. Asset-pricing models generally specify compensation for bearing systematic risk. Thus, a compensation mechanism that can reduce the risk of systemic distress 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. New covenant requirements seem unlikely, however. 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."[35] Indeed, a focus on "long-term equity" is reflected in the RiskMetrics Compensation "GRId," which bases a third of the company's score on the proper design of long-term incentive plans.[36] 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 for financial firms. As noted above, the Dodd-Frank financial regulatory reform legislation contains a "Say on Pay" provision for all public firms, including, of course, financial firms.[37] 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 Federal Reserve and other financial regulators to promote or even mandate as part of the ongoing "guidance" of large financial firm compensation practices.[38] This approach addresses the effect

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[35] COUNCIL OF INSTITUTIONAL INVESTORS, TOP 10 RED FLAGS TO WATCH FOR WHEN CASTING AN ADVISORY VOTE ON EXECUTIVE PAY 2 (2010), *available at* www.cii.org/UserFiles/file/resource%20center/publications/March%202010%20-%20Say%20on%20Pay%20Checklist.pdf; *see also* Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010) (surveying recent calls for a long-term focus in financial firm compensation).

[36] Adam O. Emmerich, *Understanding Risk Metrics Compensation "GRId"*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (June 1, 2010, 9:31 AM), http://blogs.law.harvard.edu/corpgov/2010/06/01/understanding-risk metrics-compensation-grid.

[37] *See supra* text accompanying note 9.

[38] Section 956(b) of the Dodd-Frank Act requires financial regulators to promulgate regulations that prohibit compensation practices by covered financial institutions (those with at least $1 billion in assets) that provide officers or employees "with excessive compensation, fees, or benefits" or "could lead to material financial loss to the covered financial institution." 12 U.S.C. § 5641 (2012). Financial regulators have proposed an implementing rule. *See* Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011). The proposed rule would incorporate the Guidance on Sound Incentive Compensation Policies, previously adopted by the federal banking agencies, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of

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, 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 for 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 through private ordering because of the organizational advantages of potential blocking coalitions made up of management and large shareholders as opposed to diversified shareholders.

V. 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.

Thrift Supervision. *See* 75 Fed. Reg. 36,395-02 (June 25, 2010). The proposed rule or its successors could include a requirement for convertible equity-based pay. *Id.* Another basis for regulatory intervention is Section 166 of the Dodd-Frank Act mandating that the Federal Reserve require measures for "early remediation" of financial distress of systemically important financial institutions. 12 U.S.C. § 5366 (2012). A compensation feature that assures appropriate managerial incentives in a firm facing financial distress would be a useful, additional component.

Ever since Chancellor Allen's famous footnote in the *Credit Lyonnais* case,[39] 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 the priority 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 attempted to mitigate this problem by permitting, but not obligating, the board of a firm that is in the "zone of insolvency" to consider creditor interests, not just shareholder interests.[40] Nevertheless, the creditors can bring a derivative claim for detrimental actions taken *after* the corporation becomes insolvent, such as the negative net

[39] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *1155 n.55 (Del. Ch. Dec. 30, 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 would be 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. *Id.*; *see also* Bo Becker & Per Stromberg, *Equity-Debtholder Conflicts and Capital Structure* (Harv. Bus. Sch., Nat'l Bureau of Econ. Research, Working Paper No. 10-070, 2010), *available at* http://ssrn.com/abstract=1555660 (describing the capital structure effects of *Credit Lyonnais*).

[40] Prod. Res. Grp., LLC v. NCT Grp., Inc., 863 A.2d 772, 788–89 (Del. Ch. 2004) (providing "shield" against shareholder objection, not a "sword" for creditor imperative); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 100 (Del. 2007).

present value bet that favors the shareholders over the interests of the corporation.[41]

A systemically important financial firm in the zone of insolvency presents, however, an additional kind of fiduciary duty challenge for the board due to 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 interest with public shareholders akin to that in a management buy-out. Preservation of the CEO's upside may entail a high risk of systemic distress losses 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.[42]

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 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

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[41] *See Prod. Res. Grp.*, 863 A.2d at 792; *Gheewalla*, 930 A.2d at 101–02; *see also* Dianne F. Coffino & Charles H. Jeanfreau, *Delaware Hits the Brakes: The Effect of* Gheewalla *and* Trenwick *on Creditor Claims*, 17 NORTON J. BANKR. L. & PRAC. 63 (2008). *See generally* Henry T.C. Hu & Jay L. Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007) (providing a critical perspective on this doctrinal development).

[42] This conflict would be important even for those who would minimize the significance of the shareholder/director conflict in the vicinity of insolvency. The same is true for those who decry the doctrine as unhelpfully collapsing the state law corporate governance regime—aimed at protecting shareholder interests—into the federal bankruptcy regime, triggered by a concrete legal event that results in judicial oversight of a mechanism for creditor protection. *See generally* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duty in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335 (2007).

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.[43]

VI. 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

[43] One potential objection is that the board's shareholder focus is generally limited to interests with respect to the particular firm, not "systematic" 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, nonshareholder interests can be reasonably well protected through contract and tort; this is 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 distress costs if the firm fails. Moreover, the issue can be framed more narrowly: the conflict is between managerial shareholders and other non-managerial shareholders, a classic trigger for board concern.

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*, the Court regarded the CEO's upcoming mandatory retirement as undermining the board's entitlement to rely on his judgment about a cash offer for the firm. 488 A.2d 858, 865–66 (Del. 1985). 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 who lacked pressing short-term objectives. *Van Gorkom*, 488 A.2d at 865–66. 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.

the social risk of systemic distress. It does this by forcing a mandatory conversion of senior managers' equity into subordinated debt on a 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, which would damage values across their portfolios and would increase the systematic risk premium. Because of the improvement in diversified shareholder welfare, convertible equity-based pay could be pursued by private corporate governance activism. It would also be a useful approach for the Fed's regulation of executive compensation in systemically important financial firms.