

REGULATING COMPENSATION

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I. INTRODUCTION

In the fall of 2008, the United States economy experienced what has been called a financial crisis, and what this article labels a “contracts crisis.” The exact nature of this crisis, its causes and its effects will be analyzed and discussed for decades to come.¹ Industries, agencies, firms and individuals as diverse as mortgage brokers, investment banks, ratings agencies, derivatives traders, the Securities and Exchange Commission (“SEC”) and homeowners have been blamed.² Though scrutiny has focused on the rise and fall of the real estate market,³ few participants in the

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¹ In May 2009, Congress created the Financial Crisis Inquiry Commission (“FCIC”) to investigate and study the causes of the 2008 financial crisis. Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(a), 123 Stat. 1617 (2009) (to be codified at 31 U.S.C. § 3729) (stating the function of the Commission as, inter alia, “to examine the causes of the current financial and economic crisis” by examining more than twenty enumerated aspects of the U.S. regulatory system). The FCIC was required to issue a written report by December 15, 2010. *See id.* § 5(h); *see also* Sewell Chan and Eric Dash, *Staff Losses and Dissent May Hurt Crisis Panel*, N.Y. TIMES, Sept. 1, 2010, at B1 (noting that the FCIC, though it has endured a slow start and significant turnover, “held 12 days of hearings, interviewed more than 500 witnesses and pored over hundreds of thousands of pages of documents”). On January 27, 2011, the FCIC issued its final report. *See* FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011).

² Among the twenty-two areas that the FCIC was charged with examining were areas as diverse as mark-to-market accounting methods and credit ratings agencies and areas as broad as “financial institutions and government-sponsored enterprises.” *See* Fraud Enforcement and Recovery Act § 5(c).

³ The FCIC’s final report concludes that the crisis was triggered by the collapse of the housing bubble and that “the losses were magnified by derivatives such as synthetic securities.” *See* FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at xvi.

economy have escaped criticism for contributions to the financial crisis. Commentators have blamed those who incurred losses, from homeowners to financial institutions,⁴ as contributing to systemic risk;⁵ those who protected themselves from loss, however, have been branded as profiteers and speculators and blamed even more harshly.⁶

The one common criticism focused on the contracts.⁷ Though these various firms and individuals legally contracted to accept risks, these risks, at least in hindsight, were unacceptable risks,⁸ and these contracts became

⁴ *See id.* at xix (“In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly.”).

⁵ Most speakers use the term “systemic risk” to refer to any number of situations in which a triggering event has an impact on a broader group of participants. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008). Professor Schwarcz defines “systemic risk” as it applies to institutions as occurring when:

[A] trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences – sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets or both.

See id. at 198. In the Capital Asset Pricing Model, systematic risk as applied to markets refers to “risks that are general to all securities, that are associated with the performance of the economy generally, and, in the case of stocks, with the performance of the stock market.” Importantly, shareholders cannot eliminate systematic risk through diversification and firms vary in sensitivity to systematic risk. *See* WILLIAM J. CARNEY, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE* 119 (2d ed. 2010). The financial crisis may have been caused by the intersection of market systematic risk and institution systemic risk. *See* Schwarcz, *supra* note 5, at 202 (arguing that regulation should focus only on institutions that create systemic risk that endangers market systemic risk).

⁶ *See* MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010) (quoting Steve Eisman, who ran a fund that purchased derivatives that increased in value as subprime mortgages declined as saying “[b]eing short in 2007 and making money from it was fun, because we were short *bad guys*. In 2008 it was the entire financial system that was at risk. We were still short . . . It’s sort of like the flood’s about to happen and you’re Noah.”).

⁷ Professor David Skeel writes that the Dodd-Frank Act aims to reform “both the *instruments* and *institutions* of the new financial world,” focusing on one type of instrument: derivatives. *See* DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2011).

⁸ *See* FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at xix (“[Major financial firms] took on enormous exposures in acquiring and supporting subprime

toxic. That the contracting parties entered into these agreements nevertheless can be ascribed to various failures: individual decision-making failures,⁹ captive gatekeepers,¹⁰ skewed incentives,¹¹ complexity or just plain greed.¹² Therefore, commentators targeted these areas of weakness and analyzed whether existing regulation of these areas, if any, was sufficiently lax to require that it be revisited. Theoretically, if regulation could mandate that contracting parties volunteer more information, retain certain amounts of risk or forbear from entering into certain kinds of contracts, then nationwide economic disaster could be avoided in the future.

Viewed in this way, the financial crisis can be framed as a “contracts crisis.” Just as perceived torts crises, which create unpalatable torts obligations for repeat players, spawned legislative efforts at tort law reform, the perceived contracts crisis has in turn inspired legislators to try to reform existing and future contracts and the law that governs them.

Regulatory scrutiny focused on both the internal workings of financial institutions and on the external contractual relationships between these institutions and other firms. Even as the causes of the economic meltdown were still being investigated, legislation was being proposed and even approved.¹³ During this post-crisis period, almost any financial contract was deemed worthy of regulatory interest: mortgage loan documents, mortgage broker contracts, bond indentures relating to the sale of mortgage-

lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products. Like Icarus, they never feared flying ever closer to the sun.”).

⁹ See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 39–41 (2008) (concluding that mortgage loan consumers make costly mistakes and accept terms more expensive than they could qualify for elsewhere).

¹⁰ See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at xviii (“Too often, [the regulators] lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee.”).

¹¹ See BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE* 130 (2010) (describing the compensation plans of mortgage brokers at Ameriquest that incentivized the brokers to focus on mortgage volume, not quality).

¹² See *id.* at 83 (laying blame on both gambling homeowners and pushy lenders: “The line between predatory lending and get-rich-quick speculating—or a desperate desire for cash—was often difficult to discern.”).

¹³ The most significant piece of legislation to emerge from the 2008 crisis was the Dodd-Frank Act, signed into law by President Barack Obama on July 21, 2010. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 123 Stat. 1376 (July 21, 2010). See Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 22, 2010, at B3 (quoting President Obama as referring to the 2008 financial crisis when saying “because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes.”).

backed securities, and credit default swaps and other derivatives. Though most proposed regulation would apply only to future contracts, some notable efforts were made to rewrite existing contracts, particularly in the residential mortgage industry.

This energized regulatory spirit in the financial sector, after decades of a more laissez-faire approach to capital markets, intersected with a pre-existing but largely stalled movement to regulate executive compensation.¹⁴ For years, commentators had argued that shareholders suffered when executives were awarded excessive pay packages that were not tied to whether the executives were maximizing shareholder wealth.¹⁵ Suddenly, the “pay with performance” movement had a new narrative that resonated with lawmakers and regulators: flaws in compensation schemes created incentives for individuals in firms to take on excessive risk,¹⁶ and in the aggregate, this creates systemic risk that threatens the U.S. economy. Once proponents of executive compensation reform were able to link pay without performance concerns to systemic risk concerns, then regulation was almost inevitable. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was passed in July 2010 and addresses many aspects of the financial industry, including executive compensation.¹⁷

The reform that has emerged, however, is simple executive compensation regulation wrapped up in financial crisis clothing. Neither theory nor data suggest that the compensation of a handful of individual officers at large firms, even financial firms, generated levels of firm-level risk that then contributed to the 2008 financial crisis or exacerbates systemic risk going forward.¹⁸ Moreover, the reforms that are now law bear

¹⁴ See *infra* Pt.V.A.

¹⁵ See Kenneth M. Rosen, “*Who Killed Katie Couric?*” and *Other Tales From the World of Executive Compensation Reform*, 76 *FORDHAM L. REV.* 2907, 2908 (2008) (“Compensation received by executives increasingly draws the attention not only of corporate governance specialists, but of the media, shareholders, and government officials.”).

¹⁶ See Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 *U. PA. L. REV.* 1915 (2010) (“Firms, investors, and regulators around the world are now seeking to ensure that the compensation of public company executives is tied to long-term results, in part to avoid incentives for excessive risk taking.”).

¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁸ The FCIC Report lists a number of causes of the financial crisis including particular institutions that contributed to the crisis and the short-term compensation incentives of brokers, traders, mortgage originators, and executives at each of the institutions that contributed. See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 64 (“Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions resulted in significant long-term losses or failure for investors and taxpayers.”). Perhaps seen collectively, the compensation of tens of thousands of

little theoretical connection to the types of incentive compensation plans that do lead to firm-level risk. Yet, this old solution to the old problem of management agency costs is now a proposed new solution to the new problem of systemic risk, arguably an amalgamation of management agency costs.

Interestingly, efforts to reform residential mortgages ex-post met with substantial public resistance, but executive compensation reform has not. However, both types of reform interfere with private parties' liberty to contract. Though some criticized proposals to rewrite residential loan agreements as illegitimate from a contract law point of view, the prevailing criticism focused on the undeserving nature of the borrowers who would benefit from any contractual modifications. Interfering with contracts when the interference penalizes undeserving parties, such as wealthy executives, fares better in the courts of public opinion.

However, the solution of regulating executive compensation may not only prove ineffective in alleviating systemic risk, but it may also open the door to public intermeddling with other private contracts, even in hindsight, particularly when the losing contract party is unsympathetic. The narrative of the evils of executive compensation works with the post-crisis populace because its targets are white-collar, wealthy and ostensibly responsible for the excesses that wrought the crisis. However, the new targets of compensation regulation may be blue-collar, middle-class and largely outside any of the institutions that participated in activities associated with the financial meltdown. For example, the next targets of the "undeserved" compensation debates may well be the unionized private employees and the public employees, both unionized and nonunionized.¹⁹ Overcoming any qualms that exist to interfering with negotiated contracts in the first instance may lead to an appetite to do so in the second instance.

employees may have worked to create excessive firm-level risk that then combined to create systemic risk. *But see id.* at 444–45 (dissenting commission member focusing on the explosion of nontraditional mortgages and saying that the various disparate causes listed by the majority, including compensation, could not have caused the financial crisis either alone or in the aggregate).

¹⁹ See Ron Lieber, *Battle Looms Over Huge Costs of Public Pensions*, N.Y. TIMES, Aug. 7, 2010, at B1 (describing a coming "class war" between the "haves," public employees with generous pensions and the "have-nots," the taxpayers who have declining 401(k) retirement accounts); Eileen Norcross & Todd Zywicki, *How Public Worker Pensions Are Too Rich for New York's—and America's—Blood*, N.Y. DAILY NEWS, Aug. 8, 2010, http://www.nydailynews.com/opinions/2010/08/08/2010-08-08_how_public_worker_pensions_are.html (describing the hazards of restricting benefits to current government workers, whose original contracts promised them pension benefits that state governments cannot afford).

II. FINANCIAL CRISIS AS CONTRACT CRISIS

The analogy between the contract crisis and the tort crisis is not perfect. Critics argue that the tort crisis is an ongoing, chronic problem, which began with the growth of products liability in the 1970s,²⁰ thus converting a large segment of torts lawsuits from negligence suits to “strict liability” suits.²¹ In addition, the tort law that preexists regulation is not the product of individual choice in the way that private contracts are. “Unreformed” tort law is judge-made law that governs the obligations and liabilities of strangers to one another.²² Therefore, tort reformers do not have to overcome obstacles to interfering with the choices of private citizens; they are merely reigning in activist judges and runaway juries.²³

However, though the contract crisis is being treated as an acute condition, its roots can and have been traced to the creation of the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and the securitization of residential mortgages.²⁴ If products liability is the evil villain in the torts crisis, then securitization most certainly is the villain in the contract crisis.²⁵ And

²⁰ See Mark Geistfeld, *Escola v. Coca Cola Bottling Co.: Strict Products Liability Unbound*, in TORTS STORIES 229, 240–41 (Robert L. Rabin & Stephen D. Sugarman eds., 2003) (noting that following the first strict liability products case in 1963, forty-one states had adopted the rule of products liability by 1976, riding a wave of consumers’ rights sentiment).

²¹ See, e.g., ERIC HELLAND & ALEXANDER TABARROK, JUDGE AND JURY: AMERICAN TORT LAW ON TRIAL 9 (2006) (arguing that with the creation of product liability, “[b]y the 1970s, all the legal elements were in place to expand the number of injuries that would end up in the tort system.”).

²² One area of tort law that is frequently cited in calls for tort reform is medical malpractice, which very often features plaintiffs and defendants that are not strangers but that have a pre-existing physician-patient relationship. Unlike products liability, however, medical malpractice law is not a recent creation.

²³ See HELLAND & TABARROK, *supra* note 21, at 129 (“Limiting the power of judges and juries by statute has been the preferred method of tort reform since the mid-1970s.”). In fact, Helland and Tabarrok argue that allowing plaintiffs and defendants to contract ex-ante for tort relief is the optimal reform. See *id.* at 132 (giving as an example of how contract can substitute for tort law a patient and physician contracting as to limitations of liability prior to a particular medical procedure).

²⁴ See MCLEAN & NOCERA, *supra* note 11, at 4 (“The seeds of financial disaster were sown more than thirty years ago when three smart, ambitious men, working sometimes in concert—allies in a cause they all believed in—and sometimes in opposition—competitors trying to gain advantage over each other—created a shiny new financial vehicle called the mortgage-backed security.”).

²⁵ See *id.* at 237 (quoting Lewis Ranieri, the inventor of the mortgage-backed security, as saying “I wasn’t out to invent the biggest floating craps game of all time, but that’s what happened.”).

though the contracts at issue are bargained for by private parties, critics argue that the third party in these contracts is the U.S. government, which subsidizes residential mortgages in myriad ways, including through government guarantees of conventional home loans, the home mortgage interest deduction and lax regulation. Thus, when regulators enter the fray of residential home mortgages, the status quo is not one of private contract.

Tort reform is often accompanied by consequentialist arguments: reform is necessary in order to avoid business firms exiting an industry, doctors exiting a jurisdiction, huge costs being passed on to consumers, and bankruptcies of firms if not entire industries. Recent financial reform has made the same arguments. Reform was necessary to avoid bankruptcies of financial firms and to save the health of the financial industry. Just as in product liability and medical malpractice, repeat defendants in the financial crisis would also feel financial pain. And finally, the availability of insurance (or credit default swaps (“CDS”) and other hedging techniques) skewed incentives.

The skeleton beneath the financial crisis was a chain of documents that may have once seemed unconnected, but in hindsight were largely dependent on one another. At one end of the chain were mortgages and deeds of trust signed by homeowner borrowers and financial institution lenders. These documents were then assigned to special purpose vehicles (“SPVs”) via other documents, and securities issued by those SPVs were sold via trust indentures. Accompanying these basic contracts were piles of other documents: notes, warranties, side letters, etc. The purchasers of these securities also entered into credit default swaps. Unrelated investors also purchased derivatives based on these mortgage-backed securities and these credit default swaps. However, once the real estate market began to decline and the economy began to worsen, defaults on one part of the skeleton were going to have severe impacts on other parts. Once homeowners defaulted, then issuers of mortgage backed securities (“MBS”) would default, then credit default swap sellers with too much exposure would default, and so on.

Though much of U.S. contract law rests on a fundamental premise of freedom of contract,²⁶ few in the U.S. were willing to let these contracts play out according to their terms and conditions of default. Defaulting homeowners would inevitably lead to foreclosures of the underlying residences, resulting in neighborhoods with vacant homes, glutting the resale market and lowering real estate prices. On the human side, foreclosures lead to evictions of individuals and families, disrupting

²⁶ See Mechele Dickerson, *Vanishing Financial Freedom*, 61 ALA. L. REV. 1079, 1094 (2010) (“As a nation, we value freedom of contract and our laws have long enforced contracts that contain terms that arguably are unfair to one of the contracting parties.”).

employment and education, causing domestic tragedy, and burdening social welfare systems. Defaulting MBS issuers would leave investors with huge losses, most probably not covered by the CDS insurance they purchased once the CDS issuers became insolvent and declared bankruptcy. In addition, many CDS issuers and purchasers were financial institutions that played instrumental roles in the U.S. economy and whose demise would cause jobs to disappear and threaten the U.S. banking system. To prevent all the dominos from falling at the same time, regulators stepped in to create new scenarios other than the ones anticipated by the skeleton of contracts.

Some of these reforms focused on the front end of the domino chain: the mortgages. Others focused on the end of the chain: the financial institutions. Additionally, some regulation focused on future reforms: mandating certain provisions in future contracts, prohibiting certain future contracts, limiting consideration in future contracts. However, some reforms focused on rewriting existing contracts. Another popular device to encourage contract parties to deviate from current contracts was to demonize those pressing contractual rights and pressuring them to renegotiate.²⁷

III. RESIDENTIAL MORTGAGES

A residential mortgage is at its foundation an agreement between the borrower and the lender that the lender shall lend a stated amount of money to the borrower in exchange for two things: a promise to repay under stated terms and conditions and a security interest in the residence being purchased with the loan proceeds. Under the terms of the agreement, the borrower makes scheduled payments of principal and interest. In the event that the borrower fails to make a scheduled payment and fails to cure such breach of the agreement, the lender/mortgagee has the option of terminating the agreement and taking possession of the underlying collateral. In this way, the mortgage acts as a type of liquidated damages provision—the parties have agreed beforehand that in the event of default, the mortgagee will have the right to the collateral. Because states recognize that the seizure of one's home is more disruptive than the repossession of one's car or other personal property, states have implemented various types of foreclosure procedures that must be followed. At the end of the day,

²⁷ Days before Chrysler filed for Chapter 11 bankruptcy protection, President Obama attempted to convince secured creditors to renegotiate their debt in an attempt to allow Chrysler to avoid insolvency. Two senior creditors refused, preferring to rely on their priority claims in bankruptcy, a priority that they had bargained for when originating the debt. President Obama called them out as “speculators” and remarked, “I don’t stand with those who held out when everyone else is making sacrifices.” See Zachary Krouwe, *The Lenders Obama Decided to Blame for Chrysler’s Fall*, N.Y. TIMES, May 1, 2009, at B1.

however, the mortgage agreement reflects the fact that both the borrower and the mortgagee are taking the risk that the collateral will decline in value. In fact, the mortgagee assumes this risk to a greater extent, given that the borrower has the right to “put” the residence to the mortgagee in the event that the value of the residence falls below the amount the borrower owes to the lender. However, in most economic climates, borrowers have very little incentive to strategically default on their mortgages and ruin their credit history; should housing prices fall dramatically, however, this incentive increases.

Ironically, to let these contracts terminate according to their terms and conditions may harm both the borrower and the mortgagee. On the one hand, mortgagees can be left with devalued property after a borrower defaults instead of a steady income stream of interest payments. On the other hand, a borrower who wishes to stay in the residence may be evicted from the home, losing not only equity (if any) but incurring the economic and emotional costs of relocating.

A. *Strategic Defaults*

If the borrower defaults either out of necessity or strategic choice, the mortgagee could be left with a residence whose value is lower than the amount the mortgagee had disbursed to the borrower and have to incur costs to resell that property. If a mortgagee could prevent a borrower who was able to make payments from defaulting, if the mortgagee could take away that contract right, then this would be valuable to the mortgagee.

To stem the tide of strategic defaults, government actors did not introduce regulation, but instead attempted to use moral suasion and shaming to limit the amount of strategic defaults,²⁸ even if defaulting would be the economically rational thing to do. Many commentators have argued that the mortgage agreement specifically contemplates this situation by giving the borrower the right to walk away after handing over the keys and

²⁸ See Press Release, U.S. Dep’t of Treasury, H9-856, Remarks by Secretary Henry M. Paulson, Jr. U.S. Housing and Mortgage Market Update (Mar. 3, 2008). In this press release, Secretary Henry Paulsen explained that underwater borrowers should remember that they purchased their homes for long-term use. *See id.* (“And let me emphasize, any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator—and one who is not honoring his obligations.”); Press Release, Fannie Mae, New Nationwide Survey Provides Comprehensive Look at Sentiment Toward Housing (Apr. 6, 2010), available at <http://www.fanniemae.com/newsreleases/2010/4989.jhtml?p=Media&s=News+Releases> (“The public also strongly believes in the importance of upholding the financial commitment involved in buying and owning a home, even during these challenging times when home values have fallen.”).

that exercising this right is not amoral.²⁹ However, government agencies counseling underwater homeowners stressed that continuing to make mortgage payments was the responsible thing to do.³⁰ Eventually, quasi-government actors in the home lending industry increased the extralegal penalties for strategically defaulting. Fannie Mae, the guarantor of most residential home loans, announced that strategic defaulters would be ineligible for subsequent guaranteed loans for seven years and that the firm would pursue deficiency judgments against them.³¹

A regulatory proposal that would make a borrower less likely to strategically default was aimed at reducing ex-post the principal amount of the mortgage, eliminating gap between the loan amount and the fair market value of the residence. As borrowers become more likely to default when their “negative equity” increases, eliminating the negative equity would reduce the number of strategic defaults. However, if avoiding strategic default would be worth reducing the amount of principal that would be repaid, then surely lenders would have done this without a regulatory mandate. Many have argued that the structure of the contracts limited mortgagees’ rights to modify mortgages and the benefits of those modifications.

First, modern-day mortgages are subject to securitization, which allows the mortgage originator to transfer the mortgage or the economic rights under the mortgage to one or more special purpose vehicles, which issue debt securities secured by those mortgage income streams. The conventional wisdom holds that because of the distribution of rights under the mortgages, mortgage servicers may not have the ability to modify mortgages without consent from numerous and disparate parties.³² Second, the contracts with the mortgage servicer may dampen the mortgage

²⁹ See Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Financial Crisis*, 45 WAKE FOREST L. REV. 971, 983–85 (2010) (explaining how some homeowners could save hundreds of thousands of dollars by walking away from their homes, even if their credit scores suffer in the short term).

³⁰ See *id.* at 1003 (describing the advice given by various agencies to distressed homeowners, which exaggerate the effects of default on borrowers’ financial futures).

³¹ See Press Release, Fannie Mae, Fannie Mae Increases Penalties for Borrowers Who Walk Away (June 23, 2010), available at <http://www.fanniemae.com/newsreleases/2010/5071.jhtml> (“Walking away from a mortgage is bad for borrowers and bad for communities and our approach is meant to deter the disturbing trend toward strategic defaulting.”).

³² See generally Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 SO. CAL. L. REV. 1075 (2009) (labeling mortgage-backed securities as “suicide pacts” in which all parties have made modification impossible to deter strategic threats of default).

servicer's appetite to modify mortgages, particularly lowering the principal.³³ Modifications require more man-hours, which may not be compensated, and lower principal amounts may mean lower fees.

Because of the failure of these networks of contracts, regulators proposed intervening and mandating the reduction of principal loan amounts. As discussed below, these proposals never became law. However, these proposals, though intrusive, would have also ameliorated the second negative consequence of letting mortgages terminate according to their provisions: borrowers losing their homes.

B. Borrower Home Loss

As much as a default may adversely affect a mortgagee, the borrower-mortgagor has much more to lose; which is why strategic defaults are usually last resorts made by borrowers with some disposable income. The borrower who does not have the wherewithal to make mortgage payments will suffer more from involuntary loss of residence, including expenses necessary to move and secure alternative housing. For many borrowers, a home residence is not a mere investment but also has an emotional attachment component. Even putting noneconomic considerations aside, involuntary foreclosure is a disruptive and costly influence on a borrower. However, the terms and conditions of every mortgage allow for the mortgagee to take the property and remove the borrower and any tenants from it.

Though foreclosures have been occurring for hundreds of years, the prospect of a substantial number of foreclosures happening simultaneously in the U.S., perhaps clustered in particular neighborhoods, counties or states, is a daunting one. Foreclosed properties have a negative effect not only on the borrower involved, but also on the property values of neighboring residences. One could imagine a domino effect in which reduced property values and escalating mortgage payments cause defaults and foreclosures, lowering the values of surrounding properties and starting the cycle again.

Again, the first line of governmental position was nonregulatory in nature. President Obama and others first tried moral suasion to urge lenders to enter into loan modification discussions with borrowers to avoid foreclosure. For various reasons, these loan modifications were rare.

³³ See Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 624 (2009) ("Foreclosure is often much more profitable for servicers than modification, so servicers have a strong financial incentive to foreclose on defaulted mortgages, even if a workout would be better for the MBS holders.").

Obama then proceeded to try to give lenders incentives to modify existing mortgages, by subsidizing and funding the efforts.

The second wave of regulatory response was to propose federal programs aimed at creating financial incentives for lenders to modify mortgages either by reducing the principal amount or reducing the interest rate and corresponding monthly payments. One of the first of such programs, HOPE for Homeowners, attempted to induce lenders to reduce the principal amount of underwater mortgages to 85.5% of the newly appraised value of the home. Lenders would then share in any future appreciation of the home with the mortgagor. Commentators predicted that lenders would only accept this bargain if a property's value was substantially less than the remaining loan principal.

The most comprehensive program, Home Affordable Modification Plan ("HAMP"), was announced in February 2009 (first referred to as the Homeowner Affordability and Stability Program), and offered mortgage servicers financial incentives to enroll all mortgages under their control in the program. In HAMP, homeowners could apply for a modification that would reduce payments for up to five years. Servicers, if enrolled in HAMP, would reduce interest rates and have the option to reduce principal amounts. However, a current Congressional report states that ninety-five percent of mortgages receiving permanent modifications under the plan have principal amounts larger than before the modifications (125% of the residence's value, compared with 120%).³⁴ In addition, out of 1.9 million applications, a smaller number than anticipated, only approximately 500,000 loans have been permanently modified. Accordingly, attempting to alter contract parties' incentives to amend contracts after-the-fact have not been successful.

Most commentators blame the voluntariness of HAMP as its downfall: lenders simply do not want to modify the contracts that they drafted and are willing to stick with the rights in default for which they bargained. Even the opportunity to avoid an expensive strategic default with a modification may not be that attractive to a lender who is a repeat player in the loan modification negotiation process. If negotiating with one strategic borrower results in a reduction of principal, then theoretically other underwater borrowers, who otherwise would not have defaulted, may also threaten default to receive a principal reduction. The lender who might otherwise have had to foreclose on 100 homes might have to then modify the principal not on 100 homes, but on 200 homes, or 500, or 1000. The end result would then be that the lender does not benefit economically by voluntarily modifying underwater mortgages. Therefore, lenders may not

³⁴ See CONGRESSIONAL OVERSIGHT PANEL, DECEMBER REPORT: A REVIEW OF TREASURY'S FORECLOSURE PREVENTION PROGRAMS (Dec. 14, 2010), available at <http://cop.senate.gov/reports/library/report-121410-cop.cfm>.

be voluntarily modifying these loans on their own, not because of contractual restrictions or servicer agency problems,³⁵ but because they see no benefit. Moreover, the financial incentives under HAMP do not seem to be overcoming their reluctance.

Arguably, modifying truly distressed loans in default because of job loss or other income interruption would not encourage other borrowers to follow suit and would be more beneficial to lenders than foreclosure of underwater properties.³⁶ However, these are the very loans that are the most difficult to modify. Borrowers who are unable to afford mortgage payments may have the same difficulty unless the payment is lowered substantially.³⁷ These modifications are also the most likely to go into re-default. In fact, 25.4% of HAMP-modified mortgages have gone into re-default within twelve months.³⁸

Other commentators stressed that lenders were not equipped to handle the volume of modification requests, many of which had to be underwritten again as if they were original loans. Servicers could not handle the workload, so modification efforts were lagging.³⁹ Alternatively, or aggregately, lenders preferred keeping the full loans on their balance sheets for as long as possible for accounting purposes, whereas modified loans would weaken their balance sheets.⁴⁰

³⁵ See *The Worsening Foreclosure Crisis: Is it Time to Reconsider Bankruptcy Reform?*, Hearing Before the Subcomm. on Admin. Oversight and the Courts of the Comm. on the Judiciary, 110th Cong. 4 (2009) (statement of Mark A. Calabria, Dir., Fin. Reg. Stud.), http://judiciary.senate.gov/hearings/testimony.cfm?id=3993&wit_id=8150 [hereinafter Calabria Testimony].

³⁶ However, lenders were turning down modification requests from borrowers most likely to be dependable refinancers, those who had substantial equity in their homes but had an unexpected hardship, because lenders were happy to just sell the home for the amount of the “overwater” mortgage. See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 405.

³⁷ An alternate theory suggests that many defaulting borrowers were obligated under exotic mortgages with low initial payments that “reset” to higher payments and would be able to benefit long-term from a mortgage modification. However, commentators suggest that these types of mortgages went into default at the same rate as conventional mortgages and that the existence of little or no equity given the nature of those mortgages also signal probable failure after a modification. See Calabria Testimony, *supra* note 35, at 3.

³⁸ See CONGRESSIONAL OVERSIGHT PANEL, *supra* note 34, at 89.

³⁹ See Joe Nocera, *From Treasury to Banks, an Ultimatum on Mortgage Relief*, N.Y. TIMES, July 10, 2009, at B1 (suggesting that mortgage servicers were never structured to be large-scale “full-blown underwriting shops”).

⁴⁰ See *id.* (reporting that banks prefer to “extend and pretend,” keeping defaulted properties on their books at full value rather than take losses on their balance sheets, which might affect public opinion as to their overall health).

C. Cramdown Proposals

Given the debate that the weak incentives of HAMP could not overcome mortgage servicer backload and lenders' desires to maintain their high valuations, a more intrusive regulatory proposal was introduced in both the Senate and the House of Representatives.⁴¹ This proposal would allow judges in Chapter 13 bankruptcy proceedings to modify residential mortgages unilaterally. From a freedom of contract point of view, this mandatory rewriting by a third party is substantially harder to accept than even government shaming or government incentives to rewrite valid contracts. Accordingly, this proposal has been referred to as "cramdown."⁴² It would result in reductions of principal, thereby removing negative equity and the incentive to strategically default. In addition, the modification could lower monthly payments, helping both distressed borrowers and non-distressed strategic borrowers. Lenders would be saved the transaction costs of foreclosure and perhaps achieve a desired result that is hampered by contractual restrictions in securitization structure, administrative cost and servicer incentives.⁴³ Additionally, the bankruptcy regime allows for myriad instances of "rewriting" contracts,⁴⁴ so taking a firm contractual liberty stance would ignore the realities of Chapter 13. Opponents, however, argued that creating the possibility that contracts could be rewritten in the future would lead lenders to charge higher fees and interest rates to all borrowers.⁴⁵

Ultimately, this proposal never gained full traction. Some commentators suggested that the threat of heavy-handed government

⁴¹ See Protecting Tenants at Foreclosure Act of 2009, Pub. L. No. 111-22, 123 Stat. 1660.

⁴² See Calabria Testimony, *supra* note 35, at 4 ("One 'solution' that has been regularly presented is to allow bankruptcy judges to reduce the principal balance of a mortgage loan to reflect the reduced value of the home, the so-called 'cramdown.'").

⁴³ See Levitin, *supra* note 33, at 647-48 (arguing that bankruptcy modification are the optimal solution to the foreclosure crisis and would not increase the costs of borrowing for homeowners in the future).

⁴⁴ Most similarly, mortgages of secondary residences and investment properties may be modified in Chapter 13.

⁴⁵ See Mark S. Scarberry, *A Critique of Congressional Proposals to Permit Modification of Home Mortgages in Chapter 13 Bankruptcy*, 37 PEPP. L. REV. 635, 641 (2010) ("The proposed amendments to the Bankruptcy Code would substantially alter the risk characteristics of home mortgages, with likely substantial effects on future mortgage interest rates and future mortgage availability."). *But see* Adam J. Levitin, *Back to the Future with Chapter 13: A Response to Professor Scarberry*, 37 PEPP. L. REV. 1261 (2010) (reiterating his argument that modifications of residential mortgages in bankruptcy would not increase the costs of borrowing given this current possibility for other types of mortgages and no corresponding effect).

intervention may have been a useful tool to persuade lenders to overcome obstacles to mortgage modification,⁴⁶ though there is little evidence that modifications were affected while the proposals were under consideration. Though some made the argument that this interference with contract for the benefit of one party was illegitimate,⁴⁷ the proposals probably floundered for other reasons. Most notably, critics warned of encouraging moral hazard among future borrowers and speculators and of handing windfalls⁴⁸ to irrational borrowers. Worth noting is that public appetite for ex-post contract reform seems to vary according to the sympathetic (or unsympathetic) nature of the contract parties.

IV. COMPENSATION IN THE CRISIS

Although the financial crisis extended into virtually every sector of the U.S. economy, affecting actors across industries and geographical regions, blame for the crisis focused on one city street: Wall Street. Specifically, those employees in the financial sector, whether housed in New York, Connecticut or elsewhere, who created casino-like markets to trade fictional or marginal interests in untouched, underlying assets.⁴⁹ Suddenly, attention turned on the growing “financialization” of the U.S. economy and on “speculators” who drive up prices for users and consumers of housing, credit and food.⁵⁰

Accordingly, commentators became very interested in examining not only how financial actors were compensated prior to the financial crisis, but also how they continued to be compensated after the crisis. Highly-paid investment bankers, private equity managers and other financial wizards seemed especially worthy of blame given how much they were paid to engage in the risky deals that may have sent the U.S. economy into a death

⁴⁶ See Gelpert & Levitin, *supra* note 32, at 1152 (“Moreover, the very threat of government intervention to rewrite contracts that the parties claim are too rigid to modify may act as an incentive to find private routes to modification.”).

⁴⁷ See Calabria, *supra* note 35, at 6 (“We should reject any proposed “solutions” that are based upon applying coercion to parties in what is essentially a private contract.”).

⁴⁸ For additional commentary on the rhetorical power of the term “windfall,” see Christine Hurt, *The Windfall Myth*, 8 GEO. J. L. & PUB. POL’Y 339 (2010).

⁴⁹ The FCIC Report’s majority report mentions “compensation” seventy-nine times in 410 pages. One section is entitled “The Wages of Finance” and focuses on compensation. In addition, the report highlights the annual compensation of no fewer than twenty-three individuals, obviously for effect. See generally FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1.

⁵⁰ Two recent books explore the arguably negative impact of the “financialization” of the U.S. economy. See NIALL FERGUSON, *THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD* (2008); LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* (2008).

spiral. Blaming reckless homeowners had some appeal, but they seemed to be living out the consequences of irrational borrowing. Reckless financiers merely watched others live out the consequences of their irrational financial engineering. Accordingly, calls to examine executive compensation were popular, if the end result would be some sort of negative effect on Wall Street executives. However, to support this type of scrutiny, theories emerged as to how and to what extent the compensation mechanisms common at Wall Street financial firms caused the financial crisis.

A. The Systemic Risk Argument: Individual Compensation as Incentivizing Risk-Taking

The individuals who worked and traded in this new financial arena took inappropriate risks, perhaps because their compensation packages encouraged them to do so or because they were merely playing with other people's money. The term "moral hazard"⁵¹ was introduced to the general public as a catchall phrase to describe the incentives of any person to take on additional risks due to the fact that he is not fully responsible for the potential downside consequences. Many have argued that aspects of the financial crisis may have been caused by moral hazard wherein many financial institutions, acting through thousands of employees, purchased or sold complex financial products such as credit default swaps and other derivatives that proved to be riskier to the parties involved than the price of those products reflected *ex ante*. The actual employees who made the decisions to purchase or sell these products may have made poor decisions either because their financial models did not accurately assess the risk of these products or because these employees were insulated from their own poor judgment. According to the latter theory, employees are rewarded through compensation for the volume of their financial trades or possibly

⁵¹ The most general definition of "moral hazard" refers to post-contractual incentives of contract parties to act in ways that benefit themselves to the detriment of the other. *See, e.g.*, HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 50 (2003) ("After a contract is made, a party to it may have incentives to act in a way that's detrimental to the other party to the contract."); ROBERT H. MNOOKIN ET AL., BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES 13 (2000) ("In almost every deal in which the parties have a continuing relationship there will be the potential for moral hazard. The moral hazard problem concerns post-contractual opportunism."). In the context of the financial crisis, the term's meaning is borrowed from the insurance literature, whereby someone who is insulated from her losses loses the incentive to be careful. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 196 (2007) ("If insureds possess complete coverage, the problem will be most serious, for they will then have no reason to avoid losses . . .").

according to the success of those trades, but they are not penalized for the failure of those trades.⁵²

More importantly, employees are not rewarded for abstaining from poor financial opportunities. Therefore, financial actors rationally choose to enter into riskier trades or projects on behalf of their firms.⁵³ On an individual scale, the risks of these actions are borne by the firm, reflecting on the firm's management and affecting the firm's bottom line to the detriment of shareholders, creditors and other stakeholders. If firm management believed that this incentive structure resulted, on balance, in poor decision-making and fewer profits, then management would be in the best position to supervise employees and redesign performance evaluation systems. If lower profits continued, then shareholders might exit through selling their shares and creditors might only extend credit on more stringent terms. In other words, private markets for capital and credit would respond to this "moral hazard" problem, which may be a subset of the "pay for performance" problem.⁵⁴

However, if these incentive mismatch problems are happening at multiple financial firms, and the firms are interconnected, and the firms then fail, then the economy as a whole may suffer. Should these financial bad actors all make the same risky decisions in the same time frame, then the external consequences of those choices will be felt not only by the actors' firms but by the wider universe of market participants.⁵⁵ Though the chances that these actors at different firms making the same risky decisions at the same time seems far-fetched or at least not capable of happening repeatedly over time, the decision process described above actually makes the universality of risky decisions more likely. If financial actors are rewarded for successful projects and likely not penalized for poor decisions, the likelihood of being penalized is probably diminished if the actor can

⁵² See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 64 (quoting SEC chairman Mary Schapiro as saying, "Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions result in significant long-term losses or failure for investors and taxpayers.").

⁵³ See Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 204–09 (2009) (describing in detail the skewed incentives of an asset manager who is rewarded for profits, but terminated for either no profits or losses).

⁵⁴ Arguably, pay for performance critics are also concerned with executives who do very little to enhance firm value, perhaps by taking no risks at all, whereas the moral hazard and systemic risk concerns focus on employees who decrease firm value by taking on excessive risk.

⁵⁵ See Okamoto, *supra* note 53, at 185 ("In the years leading up to the Financial Crisis, however, excessive risk taking became systemic as a series of interrelated parties took risks that compounded the exposure of the others. One party's failure led to the failure of another, which in turn led to more failures.").

assure management that others in the industry were making the same miscalculation. Furthermore, just as financial actors are not rewarded for abstaining from riskier decisions, they may in fact be penalized for abstaining from projects that ultimately prove successful, particularly if others in the industry were choosing to enter into those opportunities. Therefore, making similar decisions to others in the industry, even if risky ones, is safer for the decisionmaker than going it alone. The end result will then be that the probability of many financial firms facing setbacks in the same areas at the same time is higher than might otherwise be estimated.⁵⁶

The final phase of the moral hazard tale is that if the U.S. government believes that financial firms should be provided assistance either industry-wide or on an individual basis should the firms face catastrophe because of poor decision-making, then even the firm does not bear the ultimate risk of poor decisions.⁵⁷ Not only does the individual actor face moral hazard in that she does not bear the consequences of miscalculating risk, but the actor's firm does not either. Therefore, it may not even be in the firm's interest to work in order to align the individual's incentives to create less risk overall for the firm. The firm may benefit when risky decisions prove fruitful, but may receive government assistance should the poor decisions aggregate to threaten the firm's existence. Granted, firms may not wish to pursue this course of action because painful losses will rarely equal threatened insolvency that warrants government assistance. Managers will bear the brunt of most losses and therefore incentivizing such risky behavior will not be in their interest. However, if a coming economic crisis

⁵⁶ See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 419 (dissenting members of Commission detailing ten essential causes of the meltdown, including a "common shock" that caused unrelated financial institutions to fail because of "similar failed bets on housing" and a "risk of contagion" due to particular firms' failures "triggering balance-sheet losses in its counterparties").

⁵⁷ The implied government support of U.S. financial institutions that are systemically important has been given too much debate, often termed the "too big to fail" problem. Even after the enactment of Dodd-Frank, which purports to address the problem, Standard & Poor's announced in January 2011 that it factors the probability of government support of banks into its credit ratings system. See STANDARD & POOR'S, GLOBAL CREDIT PORTAL: BANKS 48 (2011).

Faced with a financial crisis, a government will often, but not always, provide additional support to protect confidence in its economy, in the expectation that the cost of this additional support is less damaging to the overall economy than allowing banks to fail. We recognize that financial institutions, banks in particular, fulfill the crucial functions of safeguarding national savings, allocating savings and deposits to companies and individuals in the form of loans and investments, and serving as intermediaries and agents in financial transactions.

Id.

is likely, a firm may face a moral hazard problem as insolvency becomes more and more a possibility.⁵⁸

B. *Individual Compensation as Undeserved Windfall*

Compensation has become a flashpoint in debates concerning the financial crisis because of the blame that has been heaped upon financial firms and those in that industry. To hear about these financial participants' salaries both before the crisis, during the crisis and afterward brings misery to some, particularly those hit hard by the housing crisis, economic crisis or both. Critics are especially harsh when the financial firm was a recipient of Troubled Asset Relief Program ("TARP") funds, as described below. However, the salaries of the financial participants are not logically tied to an unrelated person's job loss or credit woes. By no stretch of the imagination are these salaries zero-sum defeats for anyone else, even taxpayers. However, knowledge of highly paid executives, particularly when the companies they lead are not successful, leads to outrage from the public at large.⁵⁹

V. "PAY WITHOUT PERFORMANCE": THE PRE-2008 EXECUTIVE COMPENSATION DEBATE

The popular debate over executive compensation did not begin following the 2008 crisis, but in fact may be traced to the post-1929 crash era.⁶⁰ Moreover, in every Congressional session in recent memory,

⁵⁸ The theory that firms take on more risk as they take on leverage, which may benefit shareholders but increase losses for debtholders, is widely accepted. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 244 (Foundation Press 1986) (1995) (noting that stockholders have capped downside but unlimited upside, which makes them more risk-seeking than debtholders). This conflict is even more apparent "in the zone of insolvency." See generally Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 824 (2008) (describing efforts to extend fiduciary duties to bond creditors "in the zone of insolvency" to reduce the impact of option theory). Recently, commentators have noted that option theory gives managers even more incentive to take on risk when the firm is a banking institution. See Frederick Tung, *Bonding Bankers: Notes Toward a Governance Approach to Risk Regulation*, 4 ENTREPREN. BUS. L.J. 465 (2009).

⁵⁹ See David A. Katz, *Populist Wish Lists Offer Legislative Parade of Horribles*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 28, 2009, 10:24 AM), <http://blogs.law.harvard.edu/corpgov/2009/07/28/populist-wish-lists-offer-legislative-parade-of-horribles/#more-2824> ("Executive pay has long been a touchstone for debate and an easy target for populist-minded reformers.").

⁶⁰ See Harwell Wells, "No Man Can Be Worth \$1,000,000 a Year": *The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689 (2010).

legislation has been proposed to curb executive compensation in some way.⁶¹ Compensation paid to executives of a corporation, particularly a publicly-held corporation, is generally a very small part of a corporation's budget, yet these salaries are lightning rods for public criticism. Additionally, if boards of directors paid executives less, the benefit per employee or per shareholder of a publicly-held corporation would be negligible.⁶² However, knowledge of highly paid executives, particularly executives of unsuccessful companies, leads to outrage from the public at large.⁶³ More to the point, following the 2008 financial crisis, stories of recent executive payouts and particularly payouts following the crisis⁶⁴ enraged lawmakers and taxpayers alike.⁶⁵

Two related arguments have historically been employed in the debate over regulating executive compensation. The first is that executives should not receive pay packages that they did not earn through adding value to the company. This argument is often referred to as the pay without performance argument, after the well-known book by the same name.⁶⁶ The second argument is that executive compensation packages have

⁶¹ See, e.g., Executive Compensation Tax Reform Act of 2002, S.2722, 107th Cong.; Jobs & Growth Tax Act of 2003, S.2, 108th Cong.; Executive Stock Option Profit Recapture Act, H.R. 4208, 108th Cong. (2004); Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005); Fairness & Accountability in Reorganizations Act of 2006, H.R.5113, 109th Cong.; Income Equity Act of 2007, H.R.3876, 110th Cong.; Corporate Executive Compensation Accountability & Transparency Act, S.2866, 110th Cong. (2008) (in the current 111th Congress, no fewer than forty unique pieces of legislation have been introduced, including of course, the Dodd-Frank Act.)

⁶² But see Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 652 (2005) (arguing that, in the aggregate, curbing excessive managerial pay "would have a discernible effect on corporate earnings" but arguing that more importantly, excessive compensation distorts managerial incentives).

⁶³ See Katz, *supra* note 59.

⁶⁴ See, e.g., Paul Krugman, *The Joy of Sachs*, N.Y. TIMES, July 16, 2009, at A23 ("The bottom line is that Goldman's blowout quarter is good news for Goldman and the people who work there. It's good news for financial superstars in general, whose paychecks are rapidly climbing back to precrisis levels. But it's bad news for almost everyone else.").

⁶⁵ Post-crisis compensation packages were particularly under suspicion. See, e.g., Chad Bray, *Cuomo Seeks Data on Bonuses*, WALL ST. J., Jan. 12, 2010, at A4 (reporting that New York Attorney General Andrew Cuomo had contacted eight financial firms that had received (and repaid) TARP funds, "seeking details on the compensation paid by the banks for 2009, as well as information on how the compensation and bonus plans were determined and the scope and magnitude of lending by those firms.").

⁶⁶ LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

become excessively large in the U.S., particularly when compared to the wages of the average employee in the same company.⁶⁷

A. *Old Story #1: “Pay Without Performance”*

The pay without performance argument is difficult to counter. Of course, executives should have to earn their pay. No one would argue in favor of undeserved salary or bonuses.⁶⁸ However, one can argue that salary packages are negotiated between the executive and the company representatives, and in many cases approved by the board of directors. The executives are not solely paying themselves out of corporate funds at rates of their own choosing. Therefore, if boards of directors choose to obligate themselves to pay their executives at certain rates, then legislatures would be replacing the judgment of the board with their own judgment. And, if legislatures begin examining contracts after performance to judge whether the contract price was good in hindsight, then this violates the purpose of contracting altogether. This argument, referred to as the contractarian approach, attempts to preserve contractual freedom for the contracting parties.

Pay for performance proponents argue, however, that the parties are not contracting in a perfect environment.⁶⁹ Conflicts of interest, board capture, and opportunistic compensation consultants combine resulting in less-than-arms-length executive compensation contracts. Directors, who are otherwise delegated the power to oversee the assets of the firm, may have conflicts that prevent them from unbiased salary negotiations with executive officers who may be fellow employees of inside directors and may have social or industry ties with outside directors. In addition, even

⁶⁷ Even Bubchuk and Fried’s landmark book reminds us of the income gap at the very outset of their discussion. *See id.* at 1 (“In 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500:1.”).

⁶⁸ However, commentators have argued in favor of the undeserving giving back salary or severance packages negotiated prior to poor performance, but paid after poor performance. *See* Josh Fineman, *Nardelli Exit Package Called “Outrage,” May Heighten Pay Debate*, BLOOMBERG (Jan. 3, 2007, 4:59 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a17fAyAMaI2A&refer=home> (quoting Nell Minow as saying “[Nardelli] should be giving money back to the company, not taking anything more” in response to news that exiting Home Depot CEO Robert Nardelli would receive a \$210 million severance package after his poor six years as chief executive).

⁶⁹ *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 313–18 (2009) (describing the optimal contracting theory and two countervailing theories: market forces theory, in which the market for CEO pay is thin and not robust; and managerial power theory, wherein the board is captured).

compensation committees, solely comprised of outside directors, may be suspect. Outside directors are selected by the chief executive officer to be nominated to the board, so true independence for arms-length contracting may not exist.⁷⁰ Third-party consulting firms who give executive compensation advice may also inject an industry bias in increasing pay packages that over time ratchet up the “market price” for executives.⁷¹ Therefore, safeguards should be put in place to ensure that the end products of these bounded negotiations are kept in check.

1. *Pay Without Performance Reforms*

Pay without performance regulation that focused on strict caps probably would not fare very well,⁷² while other reforms focused on the ability of shareholders to approve compensation packages (“say on pay”). If shareholders are the owners of the corporation, then they must be entitled to vote on how the assets of the corporation are spent, particularly in this realm.⁷³ Because of the conflicts of interest and the potential of board capture, the true owners, the shareholders, are the most objective arbiters of just compensation. Therefore, shareholders should be given the ability to

⁷⁰ See BEBCHUK & FRIED, *supra* note 66, at 82 (noting that other factors besides independence may align directors with CEOs, including whether the CEO appointed that director to the board).

⁷¹ See *id.* at 39 (describing how compensation consultants compile industry data to justify higher salaries, arguing that good CEOs should be paid above market and poor CEOs should be paid at market); see also BEBCHUK & FRIED, *supra* note 62, at 657–58 (“This widespread practice [of paying CEOs more than the industry average] has led to an ever-increasing average and a continuous escalation of executive pay.”).

⁷² Even Professor Bebchuk has testified that at least for non-financial firms, “[t]he government should not seek to limit the substantive arrangements from which private decision makers may choose.” *Compensation Structure & Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 6 (2009) (statement of Lucian A. Bebchuk).

⁷³ Shareholders have not been very successful, however, in litigating claims that excessive pay packages to executives breach fiduciary duties that boards owe to shareholders or constitute waste. See *In re the Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006). The Supreme Court of Delaware determined that the Board of Directors had not breached any fiduciary duties by either hiring Michael Ovitz as President under the terms of his contract, or by terminating him without cause after sixteen months, or by paying him the \$130 million due to him under the contract’s termination provision. *Id.* In so holding, Justice Jacobs points out that the day Ovitz’s hiring was announced, Disney common stock rose 4.4%, or \$1 billion. *Id.* at 40. In addition to the fact that the \$130 million package seemed not unreasonable due to the effect on share price, during the fiscal year 1996, Disney reported revenues of \$18.7 billion and costs and expenditures (of which salary is a part) of \$15.4 billion. See WALT DISNEY CORP., FACT BOOK 1996 (Consolidated Statement of Income for fiscal year ended July 30, 1996).

effectively monitor and discipline the compensation negotiation process through an approval mechanism. Until this most recent crisis, however, say on pay proposals in the United States were not successful.⁷⁴ Whether shareholders believe their managers to be overpaid or underpaid reflects an intra-firm corporate governance problem, one that has rarely been the subject of federal law.⁷⁵

Second, some reforms focused on decreasing the incidence of board capture during executive salary negotiations. For example, the Securities Exchange Commission amended Regulation S-K in 2006 to require much more extensive disclosure by public companies of executive compensation under Item 402.⁷⁶ This disclosure would be included in registration documents required by the Securities Act of 1933,⁷⁷ and periodic reports required by the Securities Exchange Act of 1934.⁷⁸ If companies were forced to disclose compensation, then they would have incentives ex-ante to pay reasonable, market-based salaries that could withstand shareholder scrutiny.⁷⁹ In addition, current shareholders and potential shareholders could use compensation information to make informed decisions on

⁷⁴ See, e.g., Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007) (requiring a nonbinding shareholder vote on executive compensation and “golden parachutes”); Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007) (introduced by then-Senator Barack Obama and requiring nonbinding shareholder vote on executive compensation and “golden parachutes”). The United Kingdom has had its version of a nonbinding say on pay regulation since 2002. See Andrew C. W. Lund, *Say on Pay’s Bundling Problems*, 99 KY. L.J. 119, 125–28 (2010–11) (concluding that the experience in the U.K. provides little evidence that say on pay disciplines firms).

⁷⁵ But see Robert B. Ahdieh, *From “Federalization” to “Mixed Governance” in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721 (2005).

⁷⁶ Executive Compensation Disclosure, Securities Act Release No. 33-8765 (Dec. 22, 2006); Executive Compensation Disclosure, Exchange Act Release No. 34-55009 (Dec. 29, 2006).

⁷⁷ See Form S-1, Registration Statement Under the Securities Act of 1933 (requiring under Item 11, Information with Respect to the Registrant, “(k) Information required by Item 402 of Regulation S-K, executive compensation”).

⁷⁸ See Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (requiring under Item 11, Executive Compensation, “the information required by Item 402 of Regulation S-K”). Form 8-K, which publicly-held firms are required to file upon the happening of certain events, requires similar compensation information to be disclosed upon either the hiring of a new executive officer or an amendment to a compensation plan. See Form 8-K, Current Report under Securities Exchange Act of 1934 (Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers).

⁷⁹ See Wells, *supra* note 60, at 757 (“There is better reason to think that the new [1930s] disclosure requirements led firms to limit executive compensation as fear of public outrage caused them to avoid the eye-popping pay packages of the 1920s.”).

whether to buy, sell or hold shares in the publicly held issuer. However, this disclosure only applies to five individuals at any firm.⁸⁰ The compensation of other employees, whether in the millions or tens of millions, need not be disclosed. Moreover, multi-million dollar compensation of non-executives need not be disclosed.⁸¹ In addition, in 2002, both the NYSE and the NASDAQ amended their listing requirements to mandate compensation committees comprising “independent directors” that make recommendations to the full board of directors on CEO compensation matters.⁸² Similarly, in order for incentive compensation to be deductible under §162(m), discussed below, the “outside directors” must certify the compensation plan.⁸³ These types of rules result in virtually all publicly-held companies having no inside directors on compensation committees. If board capture is truly interfering with arms-length negotiations between executives and boards of directors, then independent or outside directors should be less susceptible to board capture, at least in theory.

2. Bonus Compensation

Complicating conversations about executive pay is the comparatively recent but now firmly entrenched trend of including stock, stock appreciation rights or stock options in executive pay packages. Originally meant to align management’s interests with those of shareholders, the value of stock compensation should theoretically rise with the success of the firm,

⁸⁰ See Regulation S-K, Item 402 (requiring disclosure for the “principal executive officer,” “principal financial officer” and “three most highly compensated executive officers” other than the other two officers).

⁸¹ See Rosen, *supra* note 15, at 2918–19 (discussing the public comment process surrounding the SEC’s initial proposal to disclose additional, nonexecutive salaries and the eventual rejection of that proposal).

⁸² NYSE, INC., LISTED COMPANY MANUAL § 303A.05 (2004) (requiring the compensation committee to be exclusively comprised of independent directors); see also *id.* § 303A.02 (giving guidance on the definition of “independent”); NASDAQ Listing Rules 4000 Series, NASDAQ, INC. § IM 5605–6 (2009), http://nasdaq.cchwallstreet.com/NASDAQ/pdf/new_listing_rules.pdf.

Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board’s responsibility to maximize shareholder value.

The rule is intended to provide flexibility for a Company to choose an appropriate board structure and to reduce resource burdens, while ensuring Independent Director control of compensation decisions.

Id.

⁸³ I.R.C. § 162(m)(4)(C)(iii) (2006) (requiring that the compensation committee set the performance goals at the outset of the compensation plan and then certify that the goals were indeed met).

as reflected in an increasing share price. On the flip side, should management do a poor job of running the firm, the share price will decrease, thereby decreasing management compensation. The stock component of a pay package could vest immediately upon being earned or it could be used as incentive compensation upon achievement of certain benchmarks. Subsequent to the enactment of § 162(m), bonus compensation came to constitute the overwhelming majority of an executive's multi-million dollar compensation package.

One of the oldest arguments against stock-based compensation is a theoretical one. Incentive compensation assumes that any value added by an executive is reflected in an ever-increasing stock price and that all stock price increases reflect that added value and nothing else.⁸⁴ Realistically, large stock price increases may be due to exogenous effects related to the economy or the industry as a whole.⁸⁵ In fact, the stock price of a company may increase, but at a rate lower than other competitors in an industry, suggesting that management is doing a poor job, not a job worthy of cashing in stock options. On the flipside, management may be exceptionally skilled but operating during a period of economic decline.

Even putting theoretical qualms aside, stock compensation may create more problems than it solves. The most obvious unintended consequence is that incentive compensation can create incentives to commit accounting fraud.⁸⁶ Smaller reform measures have focused on penalizing strategic "massaging" of public disclosures of information in order to hit share price targets. For example, following the accounting scandals of the 2000–2001, Congress passed the Sarbanes-Oxley Act of 2002.⁸⁷ Therefore, § 304 of SOX required that bonus compensation paid to executives that was based

⁸⁴ Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 309–11 (1995) (examining traditional critiques of stock-based compensation, including the assumption that stock price is an adequate proxy for executive performance).

⁸⁵ *Cf. Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005). The Court in *Dura Pharmaceutical* stated in the context of loss causation that:

[A] lower price may reflect . . . changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price . . . [o]ther things being equal, the longer the time between purchase and sale, the more likely that this is so

Id.

⁸⁶ See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 64 (reporting that financial reporting abuses took place at Fannie Mae in the 1990s because "[t]ying compensation to earnings also, in some cases, created the temptation to manipulate the numbers.").

⁸⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, H.R. Res. 3763 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

on share price be clawed back in the event of an accounting restatement.⁸⁸ This forfeiture requirement applies only to the chief executive officer and the chief financial officer, however. Of course, accounting fraud is also criminalized under §10(b) of the Securities Exchange Act of 1934.⁸⁹

In addition to encouraging numbers myopia, contingent compensation based on a public company's stock price is fraught with other problems. Bonus compensation may also incentivize riskier behavior than shareholders would prefer. Incentive compensation may focus management attention on short-term increases in a firm's stock price, sometimes to the detriment of long-term appreciation and sometimes as a result of strategic or even fraudulent measures.⁹⁰ As became fairly clear during the financial crisis, individuals who are rewarded for upside but not penalized for downside will focus resources on riskier and riskier projects.

Finally, executives could protect themselves against stock price decline by purchasing complex financial derivatives to guarantee a return, regardless of stock price movement.⁹¹ By purchasing an equity swap from a financial intermediary, an executive could guarantee himself the income from a diversified portfolio of stocks, therefore working around the implicit limitations of stock-based compensation.⁹² The variations and opportunities to hedge the executive's equity position are numerous and widely available.

B. *Old Story #2: Income Gap Disparity*

The second argument employed to argue for compensation regulation is the wide disparity in pay between the "rank and file" employee and executives. This argument focuses on intra-firm differences but also cites the nationwide income gaps between various household earners and the

⁸⁸ 15 U.S.C. § 7243 (2006).

⁸⁹ 15 U.S.C. § 78j (2006).

⁹⁰ The FCIC Report repeatedly refers to bonus compensation systems as contributing to short-termism at financial firms generally (p. 279); Bear Stearns (p. 291); Fannie Mae and Freddie Mac (p. 323); and Lehman Brothers (p. 343). See generally FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 291.

[Bear Stearn's exposure to risky mortgage assets, its reliance on short-term funding and its high leverage] were a result of weak corporate governance and risk management. Its executive and employee compensation system was based largely on return on equity, creating incentives to use excessive leverage and to focus on short-term gains such as annual growth goals.

Id.

⁹¹ See Bank, *supra* note 84, at 321–23.

⁹² See BEBCHUK & FRIED, *supra* note 62, at 665 (reporting that empirical studies suggest that executives are able to use inside information to make decisions on when and whether to hedge stock-based compensation).

highest-paid workers in the U.S.⁹³ Income disparity is a rallying cry for politicians,⁹⁴ though economists are quick to emphasize that income disparity is only part of an economic picture.⁹⁵

For those concerned with the growing income gap, the only cure that regulation offers seems to be a cap, which would seem outrageous to most voters. The second best solution to prohibition, however, is taxation.⁹⁶ In addition, redistribution through taxation would seem to be particularly useful in closing an income gap. Therefore, in 1993 the federal government, as part of the Omnibus Revenue Reconciliation Act of 1993, eliminated the corporate tax deduction for certain executive salaries over \$1 million.⁹⁷ From a liberty of contract standpoint, this softer regulation is much less intrusive than a salary cap.⁹⁸ Boards of directors are free to contractually obligate themselves to pay whatever amounts they choose in salary and bonuses, but companies will receive the benefit of the tax deduction only for the first \$1 million of salary. In addition, the increased taxation of “excessive” salaries would theoretically result in a redistribution of that salary to the taxpayer, satisfying income gap concerns.⁹⁹ However, the non-deductibility of salaries applies only to a small number of

⁹³ See Cait Murphy, *Are the Rich Cleaning Up?*, FORTUNE, Sept. 4, 2000, at 252 (“America’s lowest-paid workers make less, as a percentage of the median wage . . . than their counterparts in any other country.”).

⁹⁴ See *Inequality in America: The Rich are the Big Gainers in America’s New Prosperity*, ECONOMIST, June 17, 2006, at 62 (stating that though Americans were generally content to let the rich get richer and just dream of getting rich, rising income disparity after 2000 eroded that optimism).

⁹⁵ See Murphy, *supra* note 93, at 252 (suggesting that ameliorating the problems of the bottom quartile is better policy than pillaging the top quartile to raise overall economic health).

⁹⁶ See Wells, *supra* note 60, at 750 (describing unsuccessful legislation in the 1930s that aimed to punitively tax executive salary “in excess of reasonable compensation” and remarking “[o]ne way to suppress an activity is to tax it”). Though several pieces of legislation were introduced to increase taxes on corporate pay, in an era when income tax levels were quite high regardless, none then were successful. See *id.* at 752 (“Congress was willing to identify high pay as a problem and take steps to mitigate it, but proved unwilling to finally step in and identify some pay as so high it should be taken away.”).

⁹⁷ I.R.C. § 162(m)(1) (2006) (“In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000”).

⁹⁸ In fact, existing contracts are unaffected. See I.R.C. § 162(m)(4)(D).

⁹⁹ Similar proposed legislation has been even more obvious, limiting deductibility of salary to twenty-five times the lowest-paid full-time employee at a particular firm. See Income Equity Act, H.R. 3876, 110th Cong. (2007).

individuals, the same set to which SEC disclosure requirements apply.¹⁰⁰ Notably, § 162(m) limits only the deductibility of “nonperformance-based compensation,”¹⁰¹ therefore encouraging large pay packages to attempt to match pay with performance, therefore purporting to meet both goals of compensation reform.¹⁰² Indeed, this reform had the intended consequence of redirecting salary into bonus compensation, the favored tool of pay for performance advocates.¹⁰³ As previously discussed, bonus compensation may be the one type of compensation that most rewards excessive risk-taking and so is counterproductive. In addition, this tax provision probably did not result in substantially more redistributed income as few companies pay straight compensation over \$1 million.

This Article argues that the income disparity argument, though the most straightforward, provides the least legitimate basis for regulation and provides the most interference with the freedom of contract. Proponents of the income disparity argument for rewriting contracts and redistribution through taxation argue that even contractually-based earnings may be windfalls and therefore subject to seizure.¹⁰⁴

¹⁰⁰ I.R.C. § 162(m)(3).

For purposes of this subsection, the term ‘covered employee’ means any employee of the taxpayer if—(A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

Id.

¹⁰¹ I.R.C. § 162(m)(4)(C).

¹⁰² See Bank, *supra* note 84, at 302 (noting that the exception for performance-based compensation was an intentional attempt to encourage incentive-based compensation over guaranteed salaries).

¹⁰³ See Victor Fleischer, *The Tax and Financial Engineering Angle*, CONGLOMERATE (Aug. 10, 2005), http://www.theconglomerate.org/2005/08/the_tax_angle.html (arguing that Michael Ovitz’ enormous severance package, the subject of an unsuccessful shareholder lawsuit, was the direct result of management’s attempts to structure a pay package with as little economic risk for Ovitz as possible while also maintaining deductibility under I.R.C. § 162(m)(4)(C)).

¹⁰⁴ See Hurt, *supra* note 48, at 358 (arguing that characterizing any portion of a contractually bargained for return as “excess” leads to troubling operational concerns based on the definition of “excess”).

VI. TARP RESTRICTIONS ON EXECUTIVE COMPENSATION

In Fall 2008, the federal government instituted a program named TARP in an attempt to bolster the troubled U.S. economy.¹⁰⁵ This program had many aspects, but the most highlighted and controversial involved the U.S. Treasury investing billions of dollars in troubled financial institutions. Following this taxpayer “bailout,” the public expressed outrage that executives and other employees from those same institutions would continue to receive large salaries and bonuses,¹⁰⁶ some pursuant to pre-existing contracts.¹⁰⁷ At the time the TARP funds were disbursed, Treasury restricted the deductibility of executive compensation to the first \$500,000 in annual compensation, thus tightening the limitation in § 162(m). However, salary and bonuses packages did not seem to decrease, at least those packages that were reported in the media.

In response to this populist outrage, newly inaugurated President Barack Obama urged Treasury to further restrict executive compensation paid by companies that received “exceptional financial recovery assistance” through the TARP program. President Obama criticized as “shameful” that executives would be “living high on the hog” after receiving assistance.¹⁰⁸ The new Treasury regulations flatly prohibited salaries above \$500,000.¹⁰⁹ In addition, executive compensation plans would be subject to a say on pay shareholder resolution and prohibiting the top twenty-five highest-paid

¹⁰⁵ Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

¹⁰⁶ Legislators took this opportunity to publicly chastise such employees. *E.g.*, H.R. Con. Res. 76, 111th Cong. (2009) (“Expressing the sense of the Congress regarding executive and employee bonuses paid by AIG and other companies assisted with [TARP] funds” and requesting that President Obama ask AIG employees to either forego such bonuses or repay the “hundreds of millions of dollars” AIG paid to such employees.).

¹⁰⁷ In one highly publicized case, Andrew J. Hall, a non-employee contractor engaged in energy trading who earned Citigroup \$2 billion in 2008 to 2009, was owed a \$100 million bonus under his contract with Citigroup. This contract became a highlight of executive compensation reform for TARP recipients, even though no executive compensation reform would ever include nonemployees and even though Hall “performed” at a level commensurate with his “pay.” See David Segal, *Trader’s \$100 Million Payday Poses Quandary for Regulator*, N.Y. TIMES, Aug. 2, 2009, at A1.

¹⁰⁸ See Stephen Labaton, *Treasury to Set Executives’ Pay at 7 Ailing Firms*, N.Y. TIMES, June 10, 2009, at A1.

¹⁰⁹ Press Release, The White House, Office of the Press Secretary, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at http://www.whitehouse.gov/the_press_office/TreasuryAnnouncesNewRestrictionsOnExecutiveCompensation/ [hereinafter Treasury Restrictions].

executives from receiving any golden parachute payments while any TARP funds remain outstanding.¹¹⁰

This compensation cap on TARP executives does not seem to fulfill the pay for performance goal for compensation reform, though any salary cap will reduce the “pay gap” at a particular firm.¹¹¹ However, a blunt salary cap actually runs counter to calls to pay for performance. Paying all chief executives \$500,000¹¹² seems to ignore any performance differentials at all. Even if one believed that all chief executives of TARP companies were poor managers not deserving of much compensation at all, the cap also applied to newly hired chief executives. Therefore, if a firm fired the chief executive whose poor performance threw the company into a tailspin that required an influx of TARP capital, and then hired the best CEO candidate in the country, the firm could only offer that candidate \$500,000.¹¹³ This limitation, in fact, could harm the firm, endangering the recovery of the firm.

If TARP executive compensation reform does not serve traditional compensation goals, then some other justification for this type of reform must be made. Though this Article explores some of the systemic risk justifications for post-crisis reforms below, the TARP salary cap does not seem to meet that goal and was not touted as such.¹¹⁴ The arguments for

¹¹⁰ *Id.*

¹¹¹ Interestingly, this concept of capping salary at firms receiving government assistance had been explored before. See Wells, *supra* note 60, at 752–53 (describing Congress’ push to cap salaries at railroad firms receiving loans from Reconstruction Finance Corporation, a federal agency established in 1932). Though salary caps were not instituted, the RFC was given the authority to deny loans to companies paying excessive compensation. *Id.*

¹¹² This argument assumes that no TARP firm paid their chief executive less than \$500,000, though several well-known CEOs have publicly refused to accept any compensation, or compensation over \$1, for symbolic purposes.

¹¹³ See Larry Ribstein, *The stupid bailout pay caps*, IDEOBLOG (Feb. 4, 2009, 10:59 AM), <http://busmovie.typepad.com/ideoblog/2009/02/the-stupid-bailout-pay-caps.html> (“Note that this proposal applies not just to the executives who messed up, but to new hires that might lift the firms out of their morass. It, therefore, not only doesn’t focus on the bad, but helps free them from competition in the executive talent market.”).

¹¹⁴ Also in June 2009, the President appointed Kenneth Feinberg to review and approve the compensation practices for executives at seven of the largest firms that had received TARP funds. Theoretically, this review process included some assessment of whether these compensation practices encouraged excessive risk-taking. See David Cho, Zachary A. Goldfarb & Tomoeh Murakami Tse, *U.S. Targets Excessive Pay for Top Executives*, WASH. POST, June 11, 2009, at A1. Not coincidentally, at the same time that the restrictions were being implemented and Feinberg was appointed, ten of the largest TARP recipients sought to repay their TARP funds in full. See Robin Sidel & Deborah Solomon, *Treasury Lets 10 Banks Repay \$68 Billion in Bailout Cash*, WALL ST. J., June 10, 2009, at A4 (noting that

the TARP compensation cap then, range from the legitimate but misguided to the illegitimate and punitive.

One argument that has frequently been made to support the use of executive compensation caps with respect to TARP recipients is that as a large creditor,¹¹⁵ the U.S. government has an interest in exerting financial discipline on its borrower.¹¹⁶ Just as a lender may negotiate for certain covenants and events of default relating to those covenants, the U.S. government may also require that its borrower use its resources in certain ways and not in others. Lenders frequently negotiate for various sorts of covenants and negative covenants that restrain spending or otherwise protect cash flow required for debt service: capital expenditure restrictions, reserve account requirements, financial debt-to-equity ratios, prohibitions or limits on additional borrowing, liens on assets, pledges not to grant liens on assets, and requirements to maintain insurance. These are valid demands of a lender, depending on the creditworthiness of the borrower, and in keeping with the credit markets.¹¹⁷ The willingness of a borrower to accept these terms will have an effect on the borrower's cost of borrowing (interest rate) or on the borrower's ability to borrow. However, limiting the compensation of executives is not a common term found in most borrowing documents, even for distressed companies.¹¹⁸

by repaying the government funds, these institutions avoid the Treasury Restrictions on pay as well as the supervision of the pay czar, appointed the same week the banks were allowed to repay their funds.)

¹¹⁵ The Treasury made its investment in the TARP recipients by purchasing nonvoting preferred stock and warrants.

¹¹⁶ See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 375 (stating the goal of Treasury for TARP recipients to have ample cash both to repay Treasury and to have money to make loans, so “[t]he enabling legislation did have provisions affecting the compensation of senior executives and participating firms’ ability to pay dividends to shareholders.”).

¹¹⁷ At this point, one must note that these borrowing covenants are bargained for by the lender and borrower as part of the negotiation process. These terms are not unilaterally imposed by the lender after the origination of a loan without consideration for that amendment.

¹¹⁸ To test the claim that limiting the compensation of executives is a reasonable lending requirement and one that would serve the purpose of ensuring repayment, this author examined publicly-available bond indentures of Fortune 500 companies and of companies that eventually filed for bankruptcy. While analysis of that data is ongoing, researchers have been unable to find a single covenant that specifically restricted executive compensation.

At the same time, on October 1, 2008, Berkshire Hathaway purchased “10% Cumulative Preferred Stock, Series G” from Goldman Sachs to provide much-needed capital. The terms of the preferred stock enumerate certain voting rights and preferences, but makes no mention of executive compensation. The Goldman Sachs Group, Inc., Current Report (Form 8-K) at Ex. 3.1 (Sept. 28, 2008), *available at*

Frankly, the absence of such a term is not surprising, given the relative size of the compensation of the chief executive or top five paid executives as compared with expenses as a whole. In a large publicly-held firm, the compensation of the top executive, including bonus compensation and stock awards, constitutes a mere fraction of one percent of revenues.¹¹⁹ If a lender is concerned that a firm have sufficient cash on hand to pay debt service, then restricting other outflows, such as capital expenditures, seems logical. Alternatively, a lender might require that a borrower maintain a particular ratio of earnings to debt or a particular level of earnings after expenses. Logically, however, a lender would not focus on a small line-item on a firm's balance sheet in order to preserve cash flow.

Therefore, from the statements made by the President, legislators and the media about the restrictions, the most obvious justification, and the least legitimate, for the TARP compensation restrictions is that the firms deserved to be punished¹²⁰ after the fact for their presumed role in the financial crisis.¹²¹ Because curbing executive compensation in this way

<http://www.sec.gov/Archives/edgar/data/886982/000095012308011720/0000950123-08-011720-index.htm>.

¹¹⁹ In 2007, the CEO of Goldman Sachs, Lloyd Blankfein, was awarded total compensation of approximately \$70 million. A former partnership, Goldman Sachs historically pays out over fifty percent of revenues in compensation. Though \$70 million is an extremely large number, it is .15% of Goldman's 2007 revenues of \$45.9 billion and .24% of its expenses. The Goldman Sachs Group, Inc., Annual Report (Form 10-K) (Jan. 29, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/886982/000095012308000857/y46519e10vk.htm>; The Goldman Sachs Group, Inc., Definitive Proxy Statement (Form DEF 14A) (Mar. 7, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/886982/000119312508049485/ddef14a.htm>. In other firms, CEO compensation is an even smaller piece of the financial picture. At Citigroup, Charles Prince was awarded salary and bonus compensation of \$25.9 million in January 2007 for 2006 performance. This amount represents .03% of Citigroup's 2007 revenues and .07% of its expenses. Citigroup Inc., Annual Report (Form 10-K) (Feb. 2, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/831001/000119312508036445/d10k.htm>; Citigroup Inc., Definitive Proxy Statement (Form DEF 14A) (Mar. 13, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/831001/000119312508055394/ddef14a.htm>.

¹²⁰ The financial firms were treated as if on probation for some presumed crime. President Obama named Kenneth R. Feinberg as the pay czar to oversee compensation packages at AIG, Citigroup, Bank of America, General Motors, Chrysler and the financing arms of two motor companies. *See Labaton, supra* note 108, at A1.

¹²¹ On January 14, 2010, President Obama announced details of a proposed "financial crisis responsibility fee" of .15% of liabilities of financial firms with at least \$50 billion in assets that received TARP or other federal crisis assistance, whether or not that assistance had been repaid. *See* Press Release, The White House, Office of the Press Secretary, President Obama Proposes Financial Crisis Responsibility Fee to Recoup Every Last Penny for American Taxpayers (Jan. 14,

serves no valid purpose, either to preserve cash flow or to align pay with performance, then the pay caps are merely a response to public outcry.¹²² Because “Wall Street” ruined our economy, “Wall Street” must somehow feel the pain of the economic downturn. Unfortunately, one of the few ways in which the federal government was able to affect financial firms was in setting restrictions on those that accepted TARP assistance.¹²³ The federal government used the rationale of accepting TARP assistance to justify the compensation restriction, but the goal was retribution. Retribution against high-paying finance executives seems to be a subset of the second traditional argument against income disparity. If that argument is persuasive as applied to all executives, then it has even more force against executives who created negative externalities for our economy as a whole.

VII. POST-2008 EXECUTIVE COMPENSATION REFORM

A. *New Story #1: Systemic Risk*

Even if one believes that scandals and crises can spawn effective and worthwhile regulation, the regulation must have a logical connection to the behavior or activity that is suspected of causing the precipitating scandal.

2010), available at <http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn>. Though earlier referred to by President Obama as a “risk tax,” this tax or fee would have been levied on thirty-five U.S. firms, and began to look like a punitive fine or spite tax. In President Obama’s statements, he made clear his purpose: “Instead of sending a phalanx of lobbyists to fight this proposal or employing an army of lawyers and accountants to help evade the fee, I suggest you might want to consider simply meeting your responsibilities.” Eric Dash, *Wall St. Weighs a Constitutional Challenge to a Proposed Tax*, N.Y. TIMES, Jan. 17, 2010, at A1. Subsequently, Wall Street firms chose to lobby against the tax and even considered fighting such a law as unconstitutional. *Id.* This proposal was not included in the final Dodd-Frank Wall Street Reform and Consumer Protection Act.

¹²² See Editorial, *Their Gamble, Everyone’s Money*, N.Y. TIMES, Aug. 9, 2009, at A14 (“Many Americans are understandably furious about the colossal bonuses making a comeback at JPMorgan Chase and Goldman Sachs while millions of people around the world are still suffering because of Wall Street’s recklessness.”).

¹²³ Many commentators have bemoaned the fact that the financial crisis did not spawn a wave of criminal prosecutions of executives at Lehman Brothers, Goldman Sachs and AIG. See, e.g., Jesse Eisinger, *The Feds Stage a Sideshow, While the Big Tent Sits Empty*, DEALBOOK (Dec. 8, 2010, 3:09 PM), <http://dealbook.nytimes.com/2010/12/08/where-are-the-financial-crisis-prosecutions> (“The world was almost brought low by the American banking system, and we are supposed to think that no one did anything wrong?”).

Following the financial crisis, the catch-all culprit was “systemic risk.”¹²⁴ Alleviating systemic risk is a legitimate goal of regulation.¹²⁵ Commentators argued, then, that executive compensation led to systemic risk; therefore, the regulation of executive compensation will alleviate systemic risk.¹²⁶ Perhaps there is a logical connection between excessive risk-taking by individuals at individual financial firms and the financial crisis. One can argue that copious amounts of interconnected risk increased systemic risk to unacceptable levels, creating a cascade of losses that touched almost all parts of the U.S. economy. In addition, firm-wide compensation plans may increase intra-firm risk that may, when duplicated at interconnected firms, increase systemic risk. However, there is no proven connection between the compensation of executive officers, particularly the top five executive officers at these firms, and excessive risk-taking and the collapse of the U.S. economy.¹²⁷

Compensation reformers have struggled over the years in effecting change based on a cry of pay with performance. However, whether shareholders of publicly-held companies are overpaying executives based on underperformance is fundamentally a private matter with private remedies. SEC rules require boards of directors to reveal compensation numbers to shareholders in disclosure documents; should shareholders

¹²⁴ The Dodd-Frank Act creates a Financial Security Oversight Council that makes determinations regarding the impact on systemic risk of particular institutions and practices. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 112(a)(1)(A), 123 Stat. 1376 (July 21, 2010) (stating as its purpose “to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace”).

¹²⁵ Schwarcz, *supra* note 5, at 205–07 (arguing that regulation in this area is justified both on an efficiency basis and as meeting public welfare goals).

¹²⁶ 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) (arguing that the outrageous compensation of the top five executives at Bear Stearns for the eight years prior to its collapse caused its failure and the financial crisis it triggered).

¹²⁷ *Id.* at 274–75.

That the firms’ executives had incentives to take excessive risks, it should be stressed, does not imply that their decisions were in fact affected by such incentives . . . Our analysis indicates that the executives’ payoffs provided them with excessive risk-taking incentives, but it does not establish that these incentives in fact had an impact on the executives’ decisions. Yet even though our analysis does not show these incentives in fact had an effect, it does show that concerns that this might have happened should not be dismissed—but rather taken seriously.

Id.

believe the compensation to be high compared with share appreciation, then shareholders are free to sell their shares quickly and instantly. Would-be sellers purchase the shares with full knowledge of publicly-available compensation plans and historical share price increases. Proposed regulation to give shareholders ex ante consideration of these plans seems of marginal value given that shares of a publicly-held company change hands many times over the course of a year.¹²⁸ Given this fact, new shareholders are constantly making an ex ante binding decision about whether the disclosed compensation plan is acceptable to them.

However, compensation reformers were able to engage the public anew following the 2008 crisis by dropping pay without performance arguments and instead adopting the compelling, but fairly illogical, argument that executive compensation schemes increased systemic risk. In addition, reformers were able to play on the second traditional argument, the income gap disparity, to buttress arguments for attempting to reduce the compensation of executives at financial firms. Moreover, the income gap between financial industry participants and the rest of the economy was also used as a rallying cry for reform.¹²⁹ Therefore, recycled executive compensation regulation marketed to alleviate systemic risk was successful. Unfortunately, not only do the new executive compensation reforms have little chance of affecting either intrafirm risk or systemic risk, but the reforms distract away from identifying the true causes, even the true compensation system causes of the 2008 financial crisis.

B. *Dodd-Frank Act of 2010*

At the same time that the Treasury was announcing limitations on executive salary for TARP recipients, the Treasury also foreshadowed

¹²⁸ In fact, in recent years the average share of stock may change hands at least twice in a year. See Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 *BUS. LAW.* 1, 11 (2010) (citing data that suggest that the annual turnover across all U.S. stock exchanges in 2008 was over 300%).

¹²⁹ See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 61 (noting that “[b]y 2007, financial sector compensation was more than 80% greater than in other businesses”); Margaret Blair, *Financial Innovation and the Distribution of Wealth and Income* 31 (Vand. U. L. Sch., Pub. L. & Legal Theory, Working Paper No. 10-32, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656451 (“The acceleration in the growth of incomes in the financial sector relative to the rest of the economy corresponds in timing to a dramatic widening of the income distribution in the U.S. that also began in the 1980s.”).

future executive compensation reforms for all publicly-held companies.¹³⁰ That same year, both congressional houses introduced legislation aimed at reforming compensation at all publicly-held companies. The Excessive Pay Shareholder Approval Act would have required a vote of sixty percent of the shareholders of an issuer before that issuer could pay an employee more than “an amount equal to 100 times the average compensation for services performed by all employees of that issuer during such taxable year.”¹³¹ This Act would satisfy concerns about the ever-increasing pay gap, though intrafirm gaps may not be as pronounced as nationwide gaps. The Corporate and Financial Institution Compensation Fairness Act, passed by the House of Representatives on July 31, 2009, would have required independent compensation committees and nonbinding shareholder say on pay.¹³² This type of familiar reform serves pay for performance goals by attempting to dampen board capture. The passage of this proposed legislation may have also served parallel punitive goals as well as passage of the bill occurred the day after media reports that nine firms receiving TARP money paid out tens of billions in bonuses in 2008.¹³³

These reforms would ultimately be combined into the Restoring American Financial Stability Act of 2010, now known as the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹³⁴ This omnibus act, filling over 800 pages as printed by the Government Printing Office, covers topics as diverse as credit ratings agencies, securitization, consumer financial products and executive compensation.

¹³⁰ See Treasury Restrictions, *supra* note 109 (including a section entitled “Long-Term Regulatory Reform: Compensation Strategies Aligned with Proper Risk Management and Long-Term Value and Growth”).

¹³¹ Excessive Pay Shareholder Approval Act, S. 1006, 111th Cong. § 2 (2009) (enacted) (amending the Securities Exchange Act at § 16).

¹³² H.R. 3269, 111th Cong. § 2(i)(1) (2009) (enacted) (“The shareholder vote shall not be binding on the issuer or the board of directors and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board . . .”).

¹³³ See Andrea Fuller, *House Approves Limits on Executive Pay*, N.Y. TIMES, Aug. 1, 2009, at A1 (“The passage of the bill [on Friday] comes after news on Thursday that companies receiving bailout money had paid bonuses of more than \$1 million each to thousands of their employees for 2008.”).

¹³⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

1. *Say on Pay*

The pay without performance argument can support several of the compensation reforms.¹³⁵ First, under § 951, shareholders in publicly-held companies must receive information and be given the right to vote on executive compensation at least once every three years in a separate resolution. However, once every six years, shareholders have the right to vote on whether this compensation vote should take place more frequently. Similar to much of the proposed legislation that preceded Dodd-Frank, this Act also makes the shareholder vote nonbinding. This type of requirement could result in boards spending shareholder dollars to hire compensation experts and legal experts to create these executive compensation packages and disclose them in proxy materials, with little effect. Arguably, nonbinding say on pay may have a deterrent effect. Any negative vote of the shareholders will be appear in the media and be a negative public relations incident for the board of directors and the executives. Therefore, savvy boards will only propose compensation plans that shareholders will approve.

Of course, all say on pay proposals assume that shareholders may in fact not approve of current compensation practices. These practices are disclosed to shareholders on an annual basis; any outrage over these salaries by shareholders would then be reflected in large selling of shares.¹³⁶ Shareholders may, in fact, not be that sensitive to executive compensation levels or practices, given the small amount that executive pay represents for most firms.¹³⁷ In the years leading up to the financial crisis, publicly-held companies routinely disclosed the compensation of executives, as required by the Securities Exchange Act. This provision presumes that disclosure at the end of a fiscal year is inadequate notice to the shareholders, leaving them not enough time to “vote with their feet” and sell their shares. Whether nonbinding ex ante disclosure every three years is more effective remains to be seen.

Assuming that shareholder consent, even nonbinding consent, is worthwhile, it cannot be so if shareholders do not receive sufficient information with which to make an informed decision. In addition, shareholders may not be able to make effective decisions over salary numbers given without context. Therefore, under § 953, the Act directs the SEC to promulgate rules requiring publicly-held corporations to not only

¹³⁵ After the financial crisis, this argument has been reshaped into the “pay for long-term performance argument,” but that phrase is too bulky for use here. *See generally* Bebchuk & Fried, *supra* note 16.

¹³⁶ *See* Strine, *supra* note 128, at 7 (observing that “Stockholders of publicly traded corporations have substantial liquidity and freedom to alienate their shares. Indeed . . . they appear to love to alienate their shares.”).

¹³⁷ *See supra* note 119 and accompanying text.

disclose the details of compensation plans, as previously required, but to disclose every year to shareholders how executive pay is connected to executive performance.¹³⁸ This information would be in addition to other information already required to be disclosed on an annual basis on Form 10-K.

2. *Income Gap Disparity*

Though the Excessive Compensation Act had proposed limiting compensation based on the gap between the lowest-paid employees and executives, Dodd-Frank requires only that publicly-held corporations make certain disclosures of this intra-firm pay gap. Under § 953(b), this annual disclosure must include (1) the median of all “total compensation” of all employees except the CEO;¹³⁹ (2) the CEO’s total compensation and (3) the ratio of (1) to (2).¹⁴⁰

Obviously, mere disclosure is a fairly weak tool to meet a goal of salary flattening, but this section clearly stems from the income gap disparity argument.¹⁴¹ In addition, intrafirm salary gaps may not correspond to nationwide salary gaps. In fact, comparing intrafirm gaps among firms in different industries may not be helpful or informative at all. For example, the intrafirm gap at a service firm, which employs mainly professionals and some administrative staff, may be much less than at a manufacturing firm, which will have salaries ranging from one of the higher-paid CEOs to those working for minimum wage.¹⁴² Finally, some commentators have

¹³⁸ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act § 953 (requiring “a clear description of any compensation required to be disclosed . . . including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”).

¹³⁹ As the disclosure requires the median of all salaries paid at publicly-held corporations, omitting the salary of the CEO should not make an appreciable difference.

¹⁴⁰ Though this section seems straightforward, multinational companies sought guidance on which non-U.S. employees to include, whether part-time employees should be included, and what constitutes “total compensation.” The SEC has not issued rulemaking on Sections 953, 954 or 955 at the time of this writing, but has announced that rules will be proposed by July 21, 2011.

¹⁴¹ See Jean Eaglesham & Francesco Guerrera, *Pay Law Sparks ‘Nightmare’ on Wall St.*, FIN. TIMES, Aug. 30, 2010, at 1 (“The law taps into public anger at the increasing disparity between the faltering incomes of middle America and the largely recession-proof multimillion-dollar remuneration of the typical corporate chief.”).

¹⁴² See Usha Rodrigues, *Executive Comp: Too Much in the Sun?*, CONGLOMERATE (Aug. 28, 2010), <http://www.theconglomerate.org/2010/08/executive-comp-too-much-in-the-sun>.

suggested that this type of regulation would create incentives for firms to outsource the lowest-wage position to narrow any intrafirm gap.

Whatever the costs of disclosing the pay gap between the CEO and the median employee salaries, the benefits of this disclosure seem quite minimal. Furthermore, the connection between an intra-pay gap and any regulatory goal is not only unstated, but also unimaginable. Assuming that a nationwide income gap is offensive to the public, then possibly some regulatory steps could be taken to try to achieve distribution, perhaps through the tax code. However, whether most Americans would choose significant income distribution is unclear. To this point, there is no connection between a nationwide income gap and an intrafirm gap. In fact, at some of the most-hated financial firms, the median salary may be quite high. Lastly, assuming intrafirm gaps are reflective of a nationwide income gap, there is no connection between income disparity and any other regulatory goal, such as reducing systemic risk. To say that the financial crisis could have been averted had the median salaries at publicly-held firms been higher or closer to the compensation of the CEO seems to have little, if any, basis.

3. *Clawback*

Though SOX provided that in the event that a publicly-held corporation restate its financials, CEOs and CFOs would have to reimburse the company for any bonus or other incentive-based compensation (including stock options) earned during a twelve month period after the erroneous financial statements were certified, Dodd-Frank goes a bit further. The new Act expands this clawback to any executive officer returning incentive-based compensation received up to three years before the date of the restatement.¹⁴³ However, this clawback is not an SEC enforcement mechanism; the SEC is directed to require national exchanges to require listed companies to include the clawback rule as a policy of each publicly-held company's compensation structure.¹⁴⁴

A clawback mechanism could be an effective tool to tailor incentive-based compensation to actual performance. Because of time lags, employees may earn bonus compensation years before the results of their performance can be adequately judged. However, this clawback provision does not address this flaw in incentive compensation. The provision only applies to CEOs and CFOs and only to accounting restatements. Therefore, this clawback is merely a strengthening of the SOX provision, which was

¹⁴³ See Dodd-Frank Wall Street Reform and Consumer Protection Act § 953.

¹⁴⁴ Notably, several firms caught in the financial crisis had such clauses in their compensation plans, but chose not to exercise them. See FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 198 (describing Citigroup's compensation practices).

aimed at reducing incentives to engage in accounting fraud, not at reducing incentives to take on excessive, but otherwise legal, risk by various employees throughout a firm.

4. *Hedging Activities*

One of the practical drawbacks of “pay for performance” incentive compensation, which strives to pay executives only when the price of stock options or other rights increases, is that executives can enter into hedging arrangements to reduce their risk of nonpayment.¹⁴⁵ From a public relations standpoint, the idea that market participants were betting against their own companies or against the market as a whole during the financial crisis seems repugnant to the general public. Section 955 of Dodd-Frank requires companies to disclose whether employees and directors are permitted to engage in hedging activities regarding company stock. This disclosure requirement is interesting from a number of perspectives. First, it is not a limitation, merely a trigger to disclose whether the employee or director is permitted to hedge against incentive-based compensation. Therefore, if a firm has a policy against hedging, then no disclosure is required to be made.¹⁴⁶

In addition, the disclosure rule applies to any employee or outside board member who receives incentive-based compensation. Therefore, any employee who receives stock options under an employee stock option plan would be included. If we are trying to align pay with performance, then linking stock prices with every employee stretches this logic. Firms for decades have issued stock options to all sorts of employees, some of whom set policy and strategy and some of whom perform mundane job functions. These types of option grants serve goals other than “pay for performance,” such as a cheap way to increase employee salaries, a way to increase employee morale by instilling a sense of ownership and company pride and a way to retain employees who otherwise might make lateral moves. Restricting an executive’s ability to hedge downside risk from a large incentive compensation package seems to be a more necessary goal than restricting a mid-level employee from hedging against a retirement package funded with company stock.

C. Excessive Risk-Taking at Financial Firms

Most of the Dodd-Frank solutions to the financial crisis recycle old executive compensation solutions meant to solve other problems: pay without performance and a growing income disparity. However, § 956 of

¹⁴⁵ See *supra* Pt. V.

¹⁴⁶ See Bebhuk & Fried, *supra* note 16, at 1951 (noting that Corporate Library data do not reveal restrictions on CEO hedging at any of the firms in its dataset).

Dodd-Frank specifically assumes that a new executive compensation solution will protect financial firms and the U.S. economy that depends on them. Under this section, the Act directs “appropriate federal regulators”¹⁴⁷ to promulgate new rules for “covered financial institutions”¹⁴⁸ to disclose their incentive-based compensation arrangements so that these same regulators can determine whether compensation plans are “excessive” and whether they “could lead to material financial loss.” Notably, regulators will be examining compensation arrangements for executives, employees, directors and principal shareholders, not just the top five executives.

At the very least, § 956(b) attempts to leave behind the symbolic top five executive compensation discussion and take aim at the compensation plans that skew incentives of many employees in the aggregate.¹⁴⁹ Assuming that such a thing as inappropriate risk exists, and assuming that certain types of compensation plans encourage that risk, the compensation of the top five executives almost certainly does not directly encourage inappropriate risks. The types of transactions, trades and activities of Wall Street financial firms that are at the heart of the financial crisis were not the handiwork of the CEO, CFO or other executives. These decisions were made further down the corporate hierarchy, where traditional executive compensation does not go. If there is a connection between incentive compensation plans, firm risk and systemic risk, then the connection is more in the middle of the corporate ladder. And, if there is a disconnect, it lies in incentive compensation that rewards upside, but treats inaction and downside as equal.¹⁵⁰

On March 30, 2011, as this Article went to press, the SEC, FDIC, Treasury Department and other agencies issued a joint proposed rule under

¹⁴⁷ These regulators are the FDIC, the Federal Reserve and the SEC, who have been working together to promulgate new rules by April 2011.

¹⁴⁸ The term “covered financial institutions” refers to the following entities with assets of \$1 billion or more: depository institutions, depository institution holding companies, registered broker-dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and any other institution that is deemed to be one by regulators. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(e)(2), 124 Stat. 1376 (2010).

¹⁴⁹ The FCIC Report focused on the annual compensation of many individuals, and several were not “top five” executives. *See* FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 1, at 198 (listing the multi-million dollar compensation of Citigroup employees who headed various divisions, but were not executive officers). The report also points out that compensation plans skewed incentives of “traders and managers.” *See id.* at 62.

¹⁵⁰ *See* Okamoto, *supra* note 53, at 206–07 (describing incentive compensation based on performance as a call option, which will induce the holder to be more risk-seeking than risk-averse).

§ 956.¹⁵¹ These rules require the entities that each agency regulates to annually disclose to the agency certain narrative descriptions of its compensation plans, without disclosing individual salaries, and explain why the firm does not believe that these plans lead to excessive compensation or material risk. Under the regulations, a plan may lead to excessive compensation depending on the following factors:

An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

(i) The combined value of all cash and non-cash benefits provided to the covered person;

(ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

(iii) The financial condition of the covered financial institution;

(iv) Comparable compensation practices at comparable covered financial institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;

(v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;

(vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

(vii) Any other factors the Commission determines to be relevant. Interestingly, during the financial crisis, one of the most striking revelations was that financial institutions were doing the same things, but very badly, and in the same way. So, to be able to justify a compensation plan on the basis that other similar institutions have similar plans seems to hardly be a way to reduce systemic risk or to police risky compensation schemes.

In order for a plan not to be deemed likely to lead to material financial loss, the plan must be one that "(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; (ii) Is compatible with effective controls and risk management; and (iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof."

¹⁵¹ See Press Release, Sec. & Exch. Comm'n, Agencies Seek Comment on Proposed Rule on Incentive Compensation (Mar. 30, 2011), *available at* <http://www.sec.gov/news/press/2011/2011-77.htm>.

If compensation can be tied to excessive risk-taking, which leads to intra-firm risk, which can lead to systemic risk worthy of federal regulation, then § 956(b) is the only aspect of the Dodd-Frank Act that can possibly fashion that regulation. However, this section may be requiring the federal government to perform an impossible task: to draft rules prohibiting compensation arrangements that encourage inappropriate risks because they are excessive or could lead to material loss. Unfortunately, the success of such future rules depends on the definitions of “inappropriate risks,” “excessive” compensation and “material” loss. At its core, §956(b) asks federal regulators to determine for all future times, what risk is inappropriate for a financial firm to take. These guidelines, or “standards,” as they are termed are fairly broad and depend on determinations of “effective controls and risk management” and “effective [board] oversight.” One unintended consequence of this provision may be to provide shareholders with a way to successfully challenge board oversight through the federal securities law where state law had previously not provided an easy remedy.

Just as shareholders or their delegated managers may be in the best position to determine whether their CEO’s performance merits her pay, shareholders or their delegated managers may be in the best position to determine which risks are inappropriate risks for the firm to take, even if that firm is systemically important. When they are wrong, they will incur losses. If the individuals took these risks without permission or outside of set parameters, then the individuals may be fired. However, sometimes managers or shareholders will be wrong. Firms may condone individuals for taking risks that seem appropriate, according to financial models or intuition or both, and they may be wrong.¹⁵² However, if we are convinced that firms will consistently be wrong, that neither the individual, or management or the shareholders can accurately identify which risks are appropriate and which are not, then the federal government would not seem to have any additional expertise with which to make such a decision.¹⁵³

Alternatively, firms could create systems whereby individuals face intra-firm liability for risky projects gone bad. However, firms may believe that such a system will encourage risk-aversion and lead to a sub-optimal level of risk.

¹⁵² See Karl S. Okamoto & Douglas O. Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159, 205 (2010) (arguing that it is unlikely that financial participants were engaging in positions they knew to be losers; therefore, either at the outset the positions were not losers or the participants were mistaken at the outset).

¹⁵³ See *id.* at 160 (“Without defining when risk taking becomes excessive, schemes to prevent executives from taking ‘too much’ risk remain fatally incoherent. Because the science for such a determination does not exist, proponents of this approach can only hope that government will get right what industry has failed to achieve.”).

Perhaps we think that firms could easily make these assessments and put controls in place but have no incentives to do so because risk is externalized to shareholders or the taxpayer. Setting the level of acceptable risk high is a win-win situation: if the risky decision proves fruitful, the firm profits, but if not then neither the individual nor the firm or the shareholders suffer. If this is the case, then perhaps regulation will fill a void. But a firm can only depend (if ever) on government subsidy or even the capped downside of a liquidation proceeding during the period when the firm is almost insolvent. For most firms, the downside risk should be enough of a consideration. Perhaps regulators will be like Goldilocks. The SEC, Treasury or FDIC will tell us which risks are appropriate, and which ones are not. However, Goldilocks never purported to be an expert on porridge, or chair-making, or bed-making. She merely knew what she liked. Section 956(b) will be a failure if the future rules merely codify the types of risk that federal regulators, who are not participants in the industry, can tolerate.

Finally, assuming that regulators know which types of risk are inappropriate, regulators will have to be able to prune away the types of compensation plans that encourage inappropriate risks. Section 956(b) does not call on regulators to prohibit risk-taking, just the compensation that encourages it. Regulating a judgment call on risk is tricky enough, but regulating a judgment call on a judgment call seems to be almost impossible.

If any type of compensation reform could decrease firm risk, and therefore systemic risk, then it would be reform that cures an individual's incentives to be more risk-seeking than risk-averse. However, this assumes that managers and shareholders do not want their employees, particularly financial traders, to be risk-seeking because they think it benefits shareholders and other stakeholders. This may actually be a false assumption as risk-taking is not only preferable at times; it is also historically encouraged in corporate governance law.¹⁵⁴ To carve out what is inappropriate and appropriate risk-taking seems a Herculean task, and perhaps one best left to those directly bearing the risk. To prohibit certain types of compensation schemes because of a perception that the scheme may encourage inappropriate risk, usurps the shareholder's ability to choose what level of risk-seeking is preferable for that firm under the untested assumption that all firm risk exacerbates systemic risk.

¹⁵⁴ Limited liability for shareholders enables shareholders to prefer risk-seeking boards of directors. More to the point, the doctrine of the business judgment rule reflects a preference for directors to be risk-seeking and shareholders to be perfectly diversified.

VIII. CONCLUSION

Crises lead to reform efforts. The torts crisis has led to statutory reform in every state and at the federal level to curb the losses felt by certain repeat players. The financial crisis may be seen as a contract crisis, which has led legislators to attempt to reform the operation of contract law, both *ex post* and *ex ante*. Generally, U.S. legislators have had little appetite for interference with private contracting. However, the housing crisis seems to reflect that various government actors have an appetite for such activity, provided the benefits of the “new” contract inure to a sympathetic contract party, to the detriment of an unsympathetic one. Executive compensation reform provides one example of an arena with unsympathetic contract parties that became an easy target of such contract reform. Though earlier efforts failed, the new rhetoric of systemic risk has lent success to compensation reform efforts. Under the guise of curbing excessive risk and its spillover effect into the financial system as a whole, Dodd-Frank Act enacted previously introduced executive compensation proposals into law. In addition, one particular provision will give regulators the fairly unprecedented power to prohibit certain types of private compensation if there is a theoretical connection with systemic risk.

This Article urges restraint by legislators to rewrite existing compensation contracts and prohibit *ex ante* other types of compensation contracts. Not only does the new executive compensation reform have little likelihood of effecting stated goals of reducing systemic risk, but regulation may have unintended consequences at financial firms. Finally, setting a precedent for interference with private contracting seems unwise. New targets of such legislative contract reform energy may be pensioners, union employees and public employees whose contractual compensation suddenly seems undeserving as well.