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"Moral Hazard and Executive Compensation"

Moral hazard is an awkward phrase that means, when a party is insulated from risk, it may behave differently than if it were fully exposed to that risk[1]. The concept has definite applicability to executive compensation. If an executive team is rewarded for the positive outcomes of good investments, but insulated from the negative consequences of investments that turn sour, then we may encourage excessive risk-taking.

It is thought that **moral hazard** has been a major contributing factor to the current financial crisis gripping Wall Street. It is directly addressed by the recent legislation enacted by Congress that grants the Treasury Department power to purchase distressed assets from banks and other financial firms. Specifically, the Act prohibits participating companies from providing compensation incentives to senior executive officers "to take unnecessary and excessive risks that threaten the value of the financial institution.[2]"

What does this phrase mean? And more importantly, how can all private sector boards, not just financial firms availing themselves of the new Federal program, consider moral hazard in designing their executive annual cash and long-term equity incentive plans?

ADDRESSING MORAL HAZARD

One way to address moral hazard in executive incentives is to avoid asymmetrical incentive structures that have a highly leveraged upside payoff with limited or no downside. The other way is to better align the financial interests of executives with the interests of long-term shareholders, not short-term speculators. This can be done by either:

(1) Having the performance period for incentives match the period required to determine whether the decision was successful (i.e., long vesting periods for incentive awards), or

(2) Providing that a portion of earned incentives or equity is held back and subject to future risk if the strong performance that justified the reward is not sustained in future years (i.e., long tail).

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[1] To paraphrase Wikipedia, the term **moral hazard** does not imply immoral behavior or fraud. Rather, the term is used by economists "to describe inefficiencies that can occur when risks are displaced, rather than on the ethics or morals of the involved parties."

[2] "Emergency Economic Stabilization Act of 2008," Section 111 (b)(2)(A); see our alert letter dated October 6, 2008 for more detail.

This opinion piece will focus on the second way -- holding back a portion of earned equity or incentive awards to remain subject to future performance.

We will start by identifying common and widespread devices that already address moral hazard in executive incentives, and then move to more complex and unusual types of devices.

COMMON AND WIDESPREAD DEVICES THAT MITIGATE MORAL HAZARD

First, stock ownership policies requiring executives to build and hold substantial ownership positions in company stock provide market penalties for management decisions and investments that look good initially, but ultimately prove unsuccessful.

- Unfortunately, most ownership policies do not transcend employment. Thus, executives who see trouble coming can quit and protect their capital by diversifying away from company stock

Second, long-term incentives themselves, typically based on cumulative corporate performance over rolling multi-year periods, provide a reasonable timeframe for either rewarding or penalizing the future results of current decisions.

- Unfortunately, such plans are rare in financial firms
- And, it is debatable whether the absence of a reward is, in fact, a penalty
- Further, long-term incentives are typically independent of annual incentives, meaning a bonus previously earned is not given back if future performance is poor

Third, recoupment or "claw back" policies are increasingly common among large companies. Born of Sarbanes-Oxley, however, they are typically only applicable to cases involving accounting fraud or misconduct resulting in restatement of prior period earnings, and rarely apply to instances of poor financial performance or poor management.

LESS COMMON DEVICES TO FURTHER MITIGATE MORAL HAZARD

The following are a series of ideas or "thought-starters" for how boards and management could act to further mitigate moral hazard in incentive design and governance practices. They are not meant to be prescriptive, but rather to stimulate thinking, and ultimately action, by the leaders of American business and their advisors.

1. **Hold stock past retirement.** Require top executives to continue to hold their ownership policy shares for a period of time after they voluntarily leave the company, for example, 12 months. The same should be required of outside directors.

2. **Prohibit "flipping" of option gains.** Require executives who exercise valuable options to hold a portion of the after-tax profit shares. For example, requiring executives to hold 25-50% of the net after-tax profit shares remaining after covering the option exercise price and taxes *for one year after exercise* is not onerous. It would function as a form of "claw back" if the executives exercised at a high point and the stock subsequently declined because of poor performance.

3. **Pay modest or no severance for failed performance.** Senior executives could be subject to two tiers of severance benefit – one, a higher tier, for "no-fault" terminations; the other, a lower tier, for "good reason" terminations relating to failed performance that fall short of "for cause" definitions. The public simply cannot understand why boards allow executives to receive multi-million dollar settlements when they are fired for leading the company to failure. It undercuts public support for good executive compensation practices and contributes to public perceptions that the game is rigged in executives' favor.

4. **Do not accelerate vesting** of unvested equity when terminating an executive for poor performance. It is better to allow vesting to continue, subject to restrictive covenants and claw back, rather than accelerate vesting at termination of employment, because the former executive then shares in subsequent stock price or performance declines that may have been caused by his or her performance.

   Merrill Lynch's board did this when terminating its CEO, with the result that Mr. Stanley O'Neal will ultimately receive far less than the $160 million reported retirement settlement.

5. **Pay part of bonus in restricted stock.** If a company has a highly leveraged annual bonus plan for its senior executives, it would be reasonable to pay a portion of bonus in short-term restricted stock. For example, 50% of bonus above target could be paid as restricted stock with a one- or two-year tail. That way, strong but unsustainable performance in the bonus year would entail a penalty in the form of a decline in restricted stock value if performance subsequently falters.

6. **"Bank" a portion of bonus.** A portion of executives' annual cash bonuses could be put into a pool that would be paid out, maybe with interest, five years after it was put in. During that five-year period, the pool would be subject to reductions and forfeiture for investments made or profits booked during the period the bonus was earned that are subsequently written off. A simple example would be asset impairment charges for acquisitions previously made for which the company overpaid.

7. **Make executives earn their bonus twice.** For companies with a highly leveraged annual bonus plan, a portion of the bonus would be mandatorily deferred in the form a three-year long-term incentive, with ultimate payment ranging from 0-150% of the deferred amount based on cumulative three-year performance vs. solid financial and market goals. While the idea sounds negative, and likely will be resisted strenuously by management, the underlying concept is sound. Its justification is that strong performance in the bonus year is not worth as much to shareholders if that strong performance is not sustained in future years.

EXECUTIVE COMPENSATION AND THE AGENCY PROBLEM

Moral hazard is one manifestation of the owner-agency problem where professional managers manage the business on behalf of absentee owners. Most large companies' executive compensation practices have as their roots addressing the owner-agency problem. Specifically, since managers are not owners, they will behave in ways to maximize their own long-term interests, rather than the owners' interests, unless the interests of managers are aligned with the long-term owners. Maximizing *short-term* shareholder value is not the goal per se, but rather building sustainable shareholder value over the long-term.

Owners want managers to take risks with their capital, but they do not want to over-stimulate the management because excessive risk-taking may ensue. It is thought that, without incentives, managers would not be willing to take the risks owners require as a condition of putting their capital to work in private enterprise. But, if we over-react to the current reactionary environment and insist that rewards and penalties be *equally balanced*, then we will be back where we started before we induced management to take risks on behalf of shareholders. That is why, in addressing the problem of moral hazard, these ideas emphasize putting a portion, but not all, of earned incentives at risk for sustainability of performance.

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These concepts are worth considering by all boards and managements concerned with sustainable value creation and with restoring the reputation of public ownership of private enterprise as a vehicle for serving the public good rather than simply a vehicle for executive wealth creation.

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