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## Paid to Fail

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In a report just filed with the United States court that is overseeing the bankruptcy of Lehman Brothers, a court-appointed examiner described how Lehman's executives made deliberate decisions to pursue an aggressive investment strategy, take on greater risks, and substantially increase leverage. Were these decisions the result of hubris and errors in judgment or the product of flawed incentives?

After Bear Stearns and Lehman Brothers melted down, ushering in a worldwide crisis, media reports largely assumed that the wealth of these firms' executives was wiped out, together with that of the firms they navigated into disaster. This "standard narrative" led commentators to downplay the role of flawed compensation arrangements and the importance of reforming the structures of executive pay.

In our study, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000-2008," we examine this standard narrative and find it to be incorrect. We piece together the cash flows derived by the firms' top five executives using data from Securities and Exchange Commission filings. We find that, notwithstanding the 2008 collapse of the firms, the bottom lines of those executives for the period 2000-2008 were positive and substantial.

Most importantly, the firms' top executives regularly unloaded shares and options, and thus were able to cash out a lot of their equity before the stock price of their firm plummeted. Indeed, the top five executives unloaded more shares during the years prior to their firms' meltdown than they held when disaster came in 2008. Altogether, during 2000-2008, the top executive teams at Bear Stearns and Lehman cashed out about \$1.1 billion and \$850 million (in 2009 dollars), respectively.

These payoffs to top executives were further increased by large bonus compensation. During 2000-2007, the top executives' aggregate bonus compensation reached (in 2009 dollars) \$300 million at Bear Stearns and \$150 million at Lehman. Of course, the earnings that provided the basis for these bonuses evaporated in 2008. But the firms' pay arrangements did not contain any "claw-back" provisions that would have enabled the firms to recoup the bonuses that had already been paid.

Combining the figures from equity sales and bonuses, we find that, during 2000-2008, the top five executives at Bear Stearns and Lehman pocketed about \$1.4 billion and \$1 billion, respectively, or roughly \$250 million per executive. These cash proceeds are substantially higher than the value of the holdings that the executives held at the beginning of the period. Thus, while the long-term shareholders in their firms were largely decimated, the executives' performance-based compensation kept them in positive territory.

The divergence between how top executives and their companies' shareholders fared raises a serious concern that the aggressive risk-taking at Bear Stearns and Lehman – and other financial firms with similar pay arrangements – could have been the product of flawed incentives. The concern is not that the top executives expected their aggressive risk-taking to lead with certainty to their firms' failure, but that the executives' pay arrangements – in particular, their ability to claim large amounts of compensation based on short-term results – induced them to accept excessive levels of risk.

It is important for financial firms – and firms in general – to reform compensation structures to ensure tighter alignment between executive payoffs and long-term results. Executives should not be able to pocket and retain large amounts of bonus compensation even when the performance on which the bonuses are based is subsequently sharply reversed. Similarly, equity incentives should be subject to substantial limitations aimed at preventing executives from placing excessive weight on their firm's short-term stock price.

Had such compensation structures been in place at Bear Stearns and Lehman, their top executives would not have been able to derive such large amounts of performance-based compensation for managing the firms in the years leading up to their collapse. This would have significantly reduced the executives' incentives to engage in risk-taking.

Indeed, calls for comprehensive and robust reform of pay structures should not be viewed as mere responses to populist anger. Such reform could do a great deal to improve incentives and prevent the type of excessive risk-taking that firms encouraged in the years preceding the financial crisis – thereby enhancing the value of companies and the wealth of shareholders. Reforms that redress these destructive incentives should stand as an important lesson and legacy of Bear Stearns, Lehman Brothers, and the crisis they helped to fuel.

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