

Lucian Bebchuk on pay and governance

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By Robert Teitelman

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The marriage of shareholder governance and the belief that excessive compensation is the root of all evil is an uneasy one, as Harvard Law School's Lucian Bebchuk reveals in a column in Tuesday's *Financial Times*. Bebchuk makes the argument that given finance's essential systemic role, the government has every right to set compensation, skirting the usual governance powers of the board, much as regulators have the right and responsibility to limit imprudent behavior. By making this argument, Bebchuk is thus trying to draw a line between, say, the big banks and the rest of corporate America.

A couple of points are evident here. Bebchuk's argument hangs on the belief -- he would claim it as a fact -- that high pay equates with high risk. (The relationship is not as obvious, or as clear, as he would suggest, but that's his shtick.) Moreover, by arguing that regulators must step in, Bebchuk is essentially admitting that shareholders and boards have failed to control a dangerous tendency. Indeed, that failure itself is self-evident, as comp quickly bounces back. Thus, in order to tackle what Bebchuk would view as a first-order regulatory problem he is willing to make an exception to the shareholder governance model, rendering governance a second-order issue. The trouble is, he is implicitly arguing that shareholder model is flawed in one of the largest sectors of public companies in the economy. If shareholders (or boards) are such chronic failures at supervision in finance, what would make them any different in, say, automobiles or computers or retail?

His answer involves moral hazard and too big to fail. In institutions that have to be bailed out by the government, shareholders get a kind of free ride. They can urge on high pay and high risk and know the government will step to save the firm or bank. "Because the failures of such companies imposes costs on taxpayers that shareholders do not internalize, shareholders' interests are served by more risk-taking than is socially desirable," he writes.

Bebchuk thus erects a new standard for judging whether shareholders can adequately supervise corporate activities like pay. Presumably, he would want to apply this same standard to other companies -- or industries -- whose failure might also create a need for a taxpayer bailout. This is a slippery standard that may change over time. After all, the government just saved General Motors Co. and Chrysler Group LLC, albeit after a bout with bankruptcy; but the fact that shareholders got wiped out is obvious only with hindsight. Two years ago, shareholders of GM, Bear Stearns Cos. or Lehman Brothers Holdings Inc. had no idea how the government would act in the event of a failure. Would shareholders of Boeing Co. (NYSE:BA), Intel Corp. (NYSE:INTC) or one of the big defense contractors take risks more freely because of the importance of their companies? What about banks that arguably aren't TBTF (the line is very murky): Should their pay be regulated? What about large hedge funds or private equity shops? And what if regulators develop a bailout system that involves wiping out bank shareholders, but reducing the systemic risk of the failed institution? Would Bebchuk then agree that pay regulation was no longer necessary?

It's not only a slippery standard but also a slippery slope. Bebchuk is still edging open a door here and allowing a major stakeholder, the government as a representative of taxpayers, into the governance equation. When it comes to control over pay versus shareholder governance, Bebchuk clearly believes it's OK to sacrifice the latter to save the former. - Robert Teitelman

See Bebchuk's column from the Financial Times

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