Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability

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Abstract

This paper, published in a symposium on the work of Adolf Berle, approaches the Berle-Dodd debate from the perspective that corporate managers have responsibilities beyond pursuing the interests of shareholders. Stock based executive compensation, designed to align managers' interests with those of shareholders, has, in the investment banking industry in particular, failed to avert, and may have caused, managers to take excessive risks that in the 2008 financial crisis inflicted great damage on creditors and on society as a whole. We describe here the broad outlines of a proposal that we will discuss in future publications in more detail to impose some measure of personal liability for a bank's debts on the most highly paid bankers. The proposal would revive two mechanisms that imposed such personal liability in an earlier era: general partnership, which was common for investment banks prior to the 1980s, and assessable stock, which was relatively common in corporations including some commercial banks through the 1930s. One proposal is that bankers earning over $3 million per year be required to enter into a partnership/joint venture agreement with the employing bank that would make them personally liable for some of the bank's debts. The other proposal is that compensation in excess of $1 million per year be paid to bankers only in stock that is assessable in the event of the bank's insolvency in an amount equal to the book value of the stock on the date of issue. In either case, the bankers' liability would not be unlimited: they would be allowed to shield $1 million from creditors. Imposing genuine downside risk through these or other vehicles for personal liability may be the best way to make bankers approach risk in a manner that reflects the potential for externalities of the sort the crisis has so dramatically demonstrated.

Introduction

The Berle-Dodd debate has for close to eighty years been a linchpin for discussion of the principal duties of corporate officers and directors. As pointed out in other papers published in this symposium issue, Berle did not repudiate Dodd's argument that officers and directors have obligations to creditors, employees and society as a whole. He did argue for legal rules that would reinforce officer's and directors' duties to shareholders,

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but his arguments were based on practical necessity. Making officers and directors responsible principally to shareholders was better than allowing them to continue to be responsible to nobody at all. Berle's arguments were perhaps easy to mischaracterize as something they were not -- broad philosophical statements about corporate purpose. As the 1930s and the Depression wore on, Berle and Dodd both recognized the broad social implications of managerial misconduct in the 1920's. With banks failing and unemployment lines growing longer, it was clear that these social implications extended well beyond the losses suffered by shareholders.[1] It was clear then – and it is clear now, in the present financial crisis--that shareholder (and even creditor) losses are only a small part of the damage done.

Here, we argue that making managers bear some personal liability for the results of their decisions may stop them from making the kinds of gambles that caused the financial crisis.

Some History

Investment and commercial banks historically used arrangements that at least tried to tie financial interests of bank managers to the fate of creditors, including customers and depositors.

In an earlier era, particularly before the 1930s, some commercial banks as well as other corporations issued assessable stock – stock that, as we explain below, may require the holder to pay additional amounts. Holders of this stock often included directors and officers. When many banks failed after the 1929 crash, assessments were instituted by state bank regulators and other receivers. Constitutional and statutory interpretation issues were litigated, but assessments were often upheld.[2] For example, in *Broderick v. Rosner*, 294 US 629(1935), an opinion written by Justice Brandeis, the Supreme Court held that under the full faith and credit clause of the United States Constitution the New York Superintendent of Banks could bring suit for assessments against New Jersey residents holding stock in a New York bank and that the defendants could not avail themselves of a New Jersey statute prohibiting institution in New Jersey of suits brought under the laws of another state to enforce stockholders' personal liability.[3] The Court,

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[1] Berle's best-known book is ADOLF A. BERLE. JR., & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). For a thoughtful analysis of Berle's work, see William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the 'Modern Corporation,'* 34 J. CORP L. 99 (2008)

[2] For general commentary on relevant case law, see *Constitutional Law. Impairment of the Obligation of Contracts. Assessment to Restore Impaired Capital* 45 HARV. L. REV. 584 (1932).

[3] Justice Brandeis's opinion opens with a description of the relevant statute: "Pursuant to article 8, 7, of the Constitution of New York, its Banking Law (Consol.Laws, c. 2) provides, section 120: 'The stockholders of every bank will be individually responsible, equally and ratably and not one for another, for all contracts, debts and engagements of the bank, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares." 294 U.S. 629, 638. Justice Brandeis then describes the procedure used in this instance against the New Jersey defendants and upheld by the Supreme Court: "[O]n December 11, 1930, Broderick pursuant to section 57 of the New York Banking Law, took possession of the Bank's business and property; that since May 6, 1931, he has been engaged in liquidating

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Justice Brandeis observes, would not allow the New Jersey defendants to escape their voluntarily assumed statutory obligation consistent with their moral obligation to the bank's depositors:

> "In respect to the determination of liability for an assessment, the New Jersey stockholders submitted themselves to the jurisdiction of New York. For 'the act of becoming a member (of a corporation) is something more than a contract, it is entering into a complex and abiding relation, and as marriage looks to domicile, membership looks to and must be governed by the law of the State granting the incorporation.' Modern Woodmen of America v. Mixer, 267 U.S. 544, 551, 45 S.Ct. 389, 41 A.L.R. 1384. . . . . Obviously recognition could not be accorded to a local policy of New Jersey, if there really were one, of enabling all residents of the State to escape from the performance of a voluntarily assumed statutory obligation, consistent with morality, to contribute to the payment of the depositors of a bank of another State of which they were stockholders."

Stock ownership was thus a lot more than a simple contract; it was a relationship that involved legal and moral obligations to the corporation's creditors. As the New York statute demonstrates, these obligations were particularly strong when the corporation was a bank. In an era before extensive federal regulation of banks, the state where a bank was chartered had the primary responsibility for defining the terms of that relationship.

Without adequate federal government oversight of banks, however, state mandated assessments of shareholders proved inadequate to control excessive risk taking. After the 1930s, the federal government kicked the commercial banks out of the stock market and other aspects of investment banking in the Glass-Steagall Act, guaranteed commercial bank deposits and regulated commercial banks for safety and soundness. Assessable stock in this post-Depression world was presumably no longer necessary because the government would tell the commercial banks how to manage their affairs.

Investment banks, on the other hand, were not regulated for safety and soundness and were subject to relatively little government oversight other than the customer protection regime imposed on broker-dealers by the 1934 Securities Exchange Act. Until the 1980s, however, most investment banks were general partnerships run by partners who were personally liable for the debts of their firms. A partner of Lehman Brothers did not want or need the government to tell him how to run his business; if the business failed the

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the same; that prior to July 1, 1932, he determined, pursuant to sections 80 and 120, that the reasonable value of the assets of the Bank was not sufficient to pay the creditors in full and that there was due them $30,000,000 in excess of such reasonable value; that the deficiency then fixed and determined has continued ever since; that upon the Superintendent of Banks is imposed the duty of making assessment upon the stockholders and enforcing the liability of stockholders for the benefit of the creditors and that actions to enforce the liability are to be brought in the name of the Superintendent; 2 that prior to July 1, 1932, he determined that an assessment of $25 against each stockholder for each share of stock held by him was required for the payment of the Bank's indebtedness; that he duly made upon each stockholder a demand for the payment thereof on August 8, 1932; and that among the stockholders upon whom such demand was made and who failed to pay are the several defendants." 294 U.S. 629, 642

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partner paid. Firms that did not exercise restraint failed in the next market downturn and they took their improvident partners with them.

All of this began to change in the 1970s. The New York Stock Exchange in 1970 changed its rules to allow brokerage firms to have a public float, a change arguably motivated by the need for outside capital. Because the limited liability of the corporate form is generally believed to be necessary to raise outside capital, limited liability rather than partnership, with its unlimited liability, became the norm. The limited liability extended, of course, not just to the outside investors but also to the former partners (who would now be "managing directors"), a fact little discussed at the time. During the 1970s and 1980s most of the major Wall Street firms switched from partnership form to corporate form; the last holdout, Goldman Sachs, did much of its business through limited liability entities until it also abandoned partnership form in 1999.

On the commercial banking side, government oversight gradually loosened, particularly with the repeal of the Glass-Steagall Act in 1999. Commercial bank holding companies, if not the banks themselves, could carry a considerable amount of risk on their balance sheets. Commercial banking and investment banking also became more difficult to distinguish. This was true not only as to the businesses they conducted; it was also true as to how they compensated their managers. Managers of both commercial and investment banks have been paid mostly in stock and stock options. The now-familiar rationale was of course that the more stock the managers owned the more faithful they presumably would be to their companies' shareholders. Shareholder primacy had become, in many influential quarters, the norm; to overstate the case (but not by much), many believed that making managers shareholders would solve everything. Thus, one of the problems that Berle identified – that managers too often don't do what stockholders want them to do -- was supposedly solved, with enormous, some would say grotesque, stock compensation plans. The broader problem that Berle and Dodd had also discussed and that Brandeis had discussed before them – that corporations and particularly banks were sometimes run in a socially irresponsible manner – was ignored.

The Financial Crisis

Until 2008. We will not discuss in detail here what happened; we will only state the obvious. The banks took excessive risks, risks that were not commensurate with the associated potential rewards. The government bailed out some of the banks at enormous cost to the taxpayer. Bank creditors lost their shirts when there was no government bailout. Bank employees lost their jobs. The world went into the deepest economic downturn since the 1930s. People lost their homes. The managers whose risk taking precipitated this crisis lost their stock and stock options.

They kept everything else. They kept the money they had earned in previous investment banking jobs where they probably took similar risks. They kept whatever portion of their compensation from their current banking job they were able to turn into cash instead of stock. If they were particularly lucky, they had left their banks for a government job regulating banks and were forced by government ethics lawyers to sell their bank stock at

the high prices that prevailed before 2008, with an Office of Government Ethics certificate of divestiture thrown in so capital gains tax would be deferred. They kept whatever family money they had. They kept their homes, their cars, their jets and everything else not tied to bank stock or stock options. Some of these managers lost an extraordinary amount of money; others less. They almost all, however, had a lot left over.

Some people may be surprised these managers took the risks they did. As we discuss below, cognitive psychology offers more than sufficient explanation for why people are likely to behave this way when the risks they take would not expose them to real financial hardship. The declining utility of money also might explain why even the most rational decision maker would take the view that once five or ten million is squirreled away from firm creditors, the rest is funny money. Taking the risks necessary to get more fame and fortune than the other man (they almost all were men) was more important than the risk that everyone might lose an enormous amount if the entire testosterone driven frenzy came crashing down. None of these managers would lose their shirt unless they had violated criminal law and went to jail, and almost all would have a few million tucked away in the pockets somewhere to help them get started with the next round once business came back.

The Psychology of Limited Liability

Imagine a casino which you can enter with no money and no chips. You are given chips when you enter the casino and the more time you spend in the casino the more chips you are given. You are supposed to gamble with your own chips and the chips of other people outside the casino called “investors” or “customers”. If you bet and win you get to keep all of your own winnings and some of the winnings from the people you gamble for. If you win big you are also given more chips as a bonus by the casino. You know, however, that they can kick you out of the casino if you talk too much about excessive risk taking by other gamblers in the casino or suggest it might be provident for the government to regulate the casino. At any time, you can leave the casino, cash in your chips, bank the money and move on to another similar casino that will let you play by the same rules with new chips. If you lose, the most you can lose is all of your chips and money of the people you were gambling for. Whatever property you had before you entered the casino is still yours. If you are lucky, however, you will cash in your chips before things get really bad, and even if things get really bad you might have enough influence in Washington to get the government to bail you out by giving you more chips.

Banking before the 2008 crisis was much the same. One might think huge equity stakes would suffice to make bankers proceed very cautiously before incurring huge risks, especially risks the bankers (at least many of them) are now plausibly claiming they didn’t understand. Apparently not.

At first blush, this might seem baffling. How could any banker not think long and hard – longer and harder than many of the bankers in investment banks did - about the real – not

remote- possibility of a huge loss of a great deal of their own money, perhaps hundreds of millions of dollars? Various terms and frameworks in psychology are available to describe the effects at issue: these include 'prospect theory'[4] and, more specifically, the 'house money effect.' The 'house money effect' is a term coined by Richard Thaler, professor at the Booth School of Business at the University of Chicago.[5] The intuition is straightforward, and he and others have found evidence to support it. A prior gain may be experienced as 'house money;' people may be far more willing to make a risky bet with house money than they would with what they might regard as 'their own money.' We share this intuition, and find this dynamic and others like it helpful in explaining why managers took the risks they took. A simple view – one that is hard pressed to understand excessive risk-taking- looks at absolutes: a computation of the expected gains and losses of a particular gamble. A more nuanced view takes into account many other things, importantly including for our purposes a reference point above or below which a particular outcome would be experienced as a gain (or loss).

More orthodox dynamics may also be at issue, such as declining marginal utility of money. Beyond a certain point, money for the sake of its purchasing power may not matter much. Thus, bankers may not have minded the prospect of huge losses: despite those losses, many of them are left over with more money than they can reasonably spend on themselves and their families. Moreover, a person may also get enormous utility out of 'being in the game' –his identity as a 'player,' or his acceptance into the elite circle of high rollers, may yield significant payoffs. There may also be payoffs to his in terms of professional and social advancement. He may be motivated, too, by fear of acquiring a reputation for being a "retrograde" banker stuck in 'luddite' modes of investing, not savvy enough to recognize and appreciate new investment strategies. In a business world obsessed with stock price, institutional shareholders and stock analysts may shun bankers who acquire a reputation for conservatism in favor of those who are willing to take big risks in highly leveraged firms (diversified shareholders generally benefit from risks taken with creditors' money). Perhaps the banker is a hyperbolic discounter, preferring to ride high for a while notwithstanding that he may later have to pay the piper.[6]

This same risk-prone banker, however, might have a very different attitude if faced with the prospect of having very little in the way of personal assets left over because he took a bad risk. Just as, for a banker assured of always being above a certain point of personal

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[4] Daniel Kahneman and Amos Tversky originally developed prospect theory in 1979. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk,* 47 ECONOMETRICA,263 (1979).

[5] *See, e.g.,* RICHARD H. THALER, QUASI-RATIONAL ECONOMICS (1994); The term first appears in a paper by Thaler and Johnson, Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice* 36 MGMT. SCI. 643 (1990),

[6] One of us has written on identity payoffs of this sort. See Claire A. Hill, *The Law and Economics of Identity*, 32 QUEENS L. J. 389 (2007).

wealth, the loss of money may not matter much, for a banker faced with the prospect of having less than a certain amount of personal wealth, the loss of yet more money may matter a lot. The curve is not linear. What thus may matter more to a banker than the absolute amount of money he has 'in the game' – that is, the amount he can lose- is his position given a worst-case scenario. The possibility of a loss of $950 million of a $ 1 billion portfolio, having $50 million left over, may matter less than the possibility of a loss of all but $1 million of just about any large portfolio.

Regardless of the explanation, it seems evident from the latest crisis that bankers are willing to take big risks, even when they stand to lose significant amounts themselves, if they are likely to have a significant amount of assets left over. Risk preferring behavior – a phenomenon referred to as "recklessness" in tort law although tort law is largely irrelevant here because corporate directors and employees are shielded from personal liability by the so called "business judgment" rule – can more effectively be reduced by focusing on what a banker would have left over after his firm's risky gamble did not succeed than the amount he personally lost in the gamble.

One final point should be made: for whatever reason, the process by which "natural selection" chooses the people who rise to the top in banking in recent years has favored bankers who, despite enormous exposure of their own stock holdings to downside risk, are willing to take big risks with the banks they work for.[7] Asking how hypothetical "rational" wealth maximizing bankers loaded with stock would approach risk may be the wrong question. Asking what types of people rise to a position in a bank where they actually have these stock holdings and the opportunity to make choices for the bank about risk, may be the right question. Asking what – other than the ineffective approach of throwing yet more stock at these bankers -- can be done to recalibrate their attitude toward risk and bring it closer in line with the more conservative expectations of society after the 2008 debacle may also be the right question.

From Partnership to Liar's Poker and Worse

Investment banking partnerships in earlier years had a real downside for manager/partners. They could lose their savings, their houses, and just about everything else. Partners were personally liable for the debts of their partnerships. This was far more downside than the prospect of an investment banker today only having to "give back" huge amounts of money earned from an investment bank because its stock tanks

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[7] On the psychological traits of people who become CEOs, see generally Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L. J. 285 (2004)

while the investment banker is allowed to keep everything else, including money made in prior and subsequent banking jobs.

In the investment banking partnerships of not so long ago it often took many years for someone to become a partner because the other partners had to be willing to risk everything on the new partner. Partners also were collectively involved in risk taking over certain dollar amounts (some would huddle together on their trading floor to discuss a big trade) because they bore the collective responsibility of paying creditors. Partners had to bail themselves out when they failed. The Glass Steagall Act separated investment banking conducted by these partnerships from commercial banking where limited liability was more common, where there would be a government bailout if a bank failed, and where the government regulated risks that banks incurred.

Salomon Brothers is one of many successful partnerships that took calculated risks-- risks for which the partners were personally responsible. Salomon, which specialized in bonds, developed its business with the expansion in government and corporate bond offerings in the years after the Great Depression. The firm had high quality bond market research, although most of this research focused on predicting interest rates and analyzing the yield curve (the relationship between the interest earned on a bond and its maturity); Salomon like the rest of Wall Street relied on the major rating agencies, Moody's and Standard & Poor's, for analysis of borrower credit worthiness.[8] In an era before credit default swaps and other recent innovations in debt markets, Salomon's bond business was considered to be one of the most boring parts of an investment banking business that was itself relatively boring. That was fine with the firm's partners who as young men had seen too much excitement in their financial affairs. In the 1960s when Salomon became

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[8] If one wanted to know the yield on a debt instrument in ancient Mesopotamia, a Salomon researcher could provide the information. See Sidney Homer, A History of Interest Rates (1963) (tracing interest rates to 2000 B.C.). Martin Leibowitz brought to the firm mathematical modeling of the yield curve. See Sidney Homer and Martin L. Leibowitz, Inside the Yield Book (1972). Henry Kaufman became Salomon's chief economist and earned his reputation as "Dr. Doom" when he consistently and usually correctly predicted that interest rates were headed up. Salomon researchers even continued to work together after they had left the firm. See Inside the Yield Book supra (2004 Bloomberg edition with forward by Henry Kaufman and two new sections by Martin Leibowitz). Analysis of borrower creditworthiness, however, was for the most part outsourced to the rating agencies (issuer-specific research for equity securities by contrast has traditionally been done by in-house analysts at most major Wall Street firms). This reliance on rating agencies apparently worked for several decades, but by the 1980s Salomon – now a limited liability corporation -- would become a key player in the development of exotic debt instruments, including Lewis Ranieri's mortgage backed securities, that made borrower creditworthiness (as well as when there was an obligation to pay) increasingly difficult to analyze. An unanswered question is whether the earlier generation of bond market researchers would have recognized that reliance on the credit rating agencies was increasingly problematic. Maybe less-than-ideally-careful investment bankers couldn't recognize less-than-ideally-careful (and/or, some argue, conflicted) rating agencies. For discussion of the problems rating agencies had in rating the securities involved in the crisis, see Claire A. Hill, *Why Did the Rating Agencies Do Such a Bad Job With Subprime Securities*, forthcoming, PITT. L. REVIEW symposium issue on The SEC, Past, Present and Future.

one of Wall Street's biggest firms, it was run by William Salomon and other senior partners who remembered the Depression. Some of them had lost everything in banking partnerships that failed and knew what it was like to be stuck personally paying a firm's creditors.[9]

Salomon's capital belonged to the partners; there were no shareholders. The money partners invested was their own, and they had to leave as much as possible of it in the firm so the firm would grow. It was not an option to make large cash distributions to the firm's partners from its profits and then raise capital for the firm from outside investors; partnerships for the most part didn't work that way (outside investors could theoretically become limited partners of investment banks, but few investors wanted such a role and most investment banks did not want them; limited partners in Salomon Brothers were mostly retired partners or family members of retired partners). Partnership tax rules made the cash flow situation even more challenging; partners paid taxes on the firm's profits whether or not the profits were distributed to them (top federal tax brackets have fluctuated but have been as high as 50% for the earned income of general partners and 70% for the unearned income of limited partners; these rates were lowered significantly in 1981). When they retired, partners usually had a significant amount of money in the firm, but it was paid out slowly over several years because the firm still needed the capital.

Investment bankers in those days could live in nice homes and put food on the table, and they even rode limousines to work. They probably spent too much of their money on cigars. They did not, however, live the lavish lifestyles that many investment bankers live today. They also did not run their firms the way investment bankers do today. With the cigars mostly gone, Wall Street, investment bankers' bodies are probably healthier, but their firms are not.

Beginning in the 1970's and 1980's many of these investment banks switched to corporate form, which brought access to huge amounts of capital from stockholders and other investors; as we noted above, New York Stock Exchange rules once prohibited brokerage firms from being publicly held, but this rule was changed in 1970. For the investment bankers who ran these firms, the switch also brought important new developments: liquidity for the money they had locked up in their firms which they

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[9] We should disclose that Sidney Homer, a partner of Salomon Brothers and head of its bond market research department until 1972, was Mr. Painter's grandfather. Earlier, Mr. Homer had started his own bond firm Homer & Co. that survived the Great Depression. When the United States entered World War II, Mr. Homer went to Washington to help Treasury Secretary Morgenthau track down Nazi bank accounts. Homer & Co. was left in the hands of a partner and soon thereafter found itself stuck with a large inventory of bonds in a bear market. The firm failed. Mr. Homer returned to New York, took a salaried job as a researcher at another firm, and spent much of the next decade paying Homer & Co. creditors. He became a partner of Salomon Brothers in 1961.

could now invest or spend as they chose,[10] a compensation system based on bonuses, stock and stock options instead of slow but steady accrual of partnership capital within the firm, and most significant to our analysis here, no personal liability for the debts of the firm. Each firm had its own story, but the impact on investment bankers' behavior seemed uniform. Limited liability -- and the moral hazard that comes with it -- is only a part of what changed Wall Street in the 1980's into the frenetic risk taking memorialized by the movie Wall Street, but limited liability was a significant part of the story.

Salomon Brothers for example switched from partnership to corporation in 1981 with its merger with Phibro Commodities. Traders had always been important at the firm, but they no longer traded only with their own money and that of their partners. Their personal assets outside of the firm were not at risk. The age of Liar's Poker had begun. Michael Lewis's description in his 1989 book[11] of the term used for a star trader -- a "Big Swinging Dick" -- reflected not only the rise of obscenity on trading floors, but also an ethos in which investment bankers engaged in risky conduct and were no longer personally responsible for their actions. Senior management steered the firm into junk bonds, and several top executives – including economist Henry Kaufman -- quit in protest. A scandal involving a rogue trader in the 1990's was disastrously handled by senior management until shareholder Warren Buffet – one of the few shareholders in America who does not have to worry about the Berle-Means problem -- intervened and fired top management.[12] By the late 1990's the firm's name had lost its luster and what remained of Salomon's investment banking business was, along with Phibro, merged into Citicorp. Citicorp could run the business as it pleased, with relatively little federal oversight (the commercial bank Citibank was kept "separate"). And one more detail: the Glass-Steagall Act, which prohibited commercial banks from getting into investment banking, had been repealed.

Ironically, it is the enormous risks posed by Phibro's commodities trading business, and the enormous compensation of over $100 million Citicorp allegedly owed to Phibro's top executive Andrew Hall, that has led Citibank itself to rethink limited liability --

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[10] Michael Bloomberg, who left the firm, is rumored to have taken $30 million out of Salomon Brothers, along with his rights to the technology that enabled him to develop a multi billion dollar financial information network.

[11] MICHAEL LEWIS, LIAR'S POKER (1989) (Lewis's account begins with his hiring by the firm in 1984 and the training class he participated in shortly thereafter). Salomon by the time Lewis joined the firm had only been a corporation for three years, but from his account it appears the culture had already changed.

[12] Nobody, including Salomon's General Counsel Don Fauerstein, reported the rogue trader's misconduct to the Board of Directors even though senior management would not do anything about it. Warren Buffet, as a member of the Board and a major investor, was understandably upset. The firm's reputation, built up over many years by its partners and employees, was ruined in a few months. The Salomon incident and other similar incidents led to proposals – eventually enacted in Section 307 of the Sarbanes-Oxley Act of 2002 -- to require corporate lawyers to address this aspect of the separation of ownership from control by reporting known illegal acts to client boards of directors.

admittedly under pressure from the federal government. Citicorp was apparently considering spinning off Phibro as a general partnership with Mr. Hall as a managing partner[13] – one way of responding to the government's uproar over Hall's compensation by a bank that had received billions in federal bailout dollars. Citicorp ended up solvng the problem in a different way – by selling Phibro along with Mr. Hall's bonus problem to Occidental Petroleum – but the fact that a general partnership was considered for such an enormous firm is significant.

Imposing (Some) Personal Liability on Managers

Much discussion about the 2008 crisis has addressed the role of bankers' compensation in precipitating the crisis. However, the principal focus has been on bankers' short time horizons on account of their receipt of huge year-end bonuses for "results" that may be fleeting or even reversed in later years. Stock options also are believed to shorten bankers' time horizons, making the bankers more prone to risk. Long term stock holdings are touted as an alternative to bonuses and stock options. Thus, there have been proposals to more carefully monitor, or restrict, upside compensation for risk taking, as well as to give shareholders a "say on pay." The agency problem, in which bankers prefer their own interests rather than the interests of those they are supposed to be working for, presumably would be minimized through better compensation schemes (only a few critics suggest smaller compensation schemes), and bankers would become better agents for the banks' shareholders.

But, as we have seen, even with large stock holdings bankers were still quite willing to have their firms make very risky investments. Many risk-taking bankers had enormous equity stakes in their companies, for example at Lehman Brothers, and they took big risks anyway. Reducing up-side reward for risk taking, or making that reward more "long term" is a solution that will only go so far. Moreover, stockholders may sometimes prefer big risks; risk taking bankers may actually be doing what the bank's shareholders want them to do. And creditors, who should have an interest in curtailing risk-taking, aren't doing so. The public bears the brunt of the cost from excessive risk taking by banks, but government regulation thus far has been inadequate to protect the public interest. Some form of personal liability for bankers is, we believe, something to consider: it may be a very effective way of reducing the risk taking that imposes such enormous cost on the public.

How would we achieve this?

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[13] Eric Dash, *Citigroup Considers Changes at Phibro*, August 7, 2009, available at http://www.nytimes.com/2009/08/07/business/07phibro.html ("Citigroup executives are considering what to do next. One option would be to transform Phibro into a partnership headed by Mr. Hall.")

It is difficult to imagine the investment banking business returning to the partnerships of old. Some investment banks – including Goldman Sachs and Morgan Stanley – have put themselves under commercial bank holding company structures for the time being in order to get access to credit from the Federal Reserve, but when the Federal Reserve money is no longer needed there will be an incentive for these banks to liberate themselves from federal regulation of commercial banks by switching back to the investment banking model they used before. Many other investment banks have remained investment banks. It is uncertain what federal regulation will be imposed on the safety and soundness of investment banks in response to the latest crisis.[14] General partnership – with the illiquidity and liability it imposes on general partners and the constraints it imposes on a bank's ability to raise capital – probably will not be considered a viable option.

But we think some form of personal liability deserves to be seriously considered. Thus, our objective here is to design a way to impose some of the risks of personal liability on the most highly compensated employees at investment banks and other financial services and trading firms. We seek to do so without requiring the firm itself to switch to general partnership form or to make any other change in its organizational structure. We discuss below two approaches, each one based on historical precedent. The first approach is a mandatory partnership/joint venture agreement between certain "covered companies" and certain "covered employees" earning over $3 million per year in compensation. These employees would enjoy their large compensation packages, but also some of the exposure to personal liability that hung over the heads of investment bankers who were in fact partners not so long ago. The second approach is requiring that these same "covered companies" pay any employee compensation over $1 million in assessable stock. The stock would be nontransferable and have a par value equal to its book value at the time of issuance (the higher the firm assets reported under GAAP the higher the stock's book value).[15] In the event of firm insolvency, the stock would be assessable in an amount equal to its book value at the time of issuance. The assessment would be a personal debt of the record holder of the stock just as it was for the unfortunate holder of assessable stock in a commercial bank that failed in the 1930s.

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[14] For one proposal see http://www.federalreserve.gov/newsevents/speech/tarullo20091102a.htm

[15] A higher par value for stock issued to managers could result in additional franchise taxes for the corporation. Because this would impose an additional tax on compensation over $1 million, it might be a good thing. If not, any federal law requiring that the high par value assessable stock be used for this purpose could bar states from taxing it or alternatively provide a federal corporate income tax credit to offset the additional franchise tax. Finally, if this remains a problem the assessment could be imposed without relating the amount of the assessment to the stock's "par value"; we suggest the link because it is the way assessable stock often worked in the past, but the assessable stock would not have to tie the amount of the assessment to par value in order to accomplish the desired purpose.

Other commentators have suggested measures that could change the behavior of bankers and other corporate executives by making them think harder about the position of creditors or of their own personal liability for mismanagement. Some of these proposals would affect compensation while others involve enhanced personal liability for demonstrated wrongdoing. For example, Lucian Bebchuk and Holger Spamann have proposed that bankers' compensation be tied to the performance of the bank's debt securities not just its stock.[16] Professor Langevoort proposed before the 2008 crisis making it easier to impose personal liability on corporate executives for securities fraud.[17] Professor Johnson has proposed not allowing corporate officers to avail themselves of the protection of the business judgment rule, which he argues is appropriate only for outside directors.[18]

These proposals are headed in the right direction, but we are concerned that they may not go far enough. The Bebchuk-Spamann compensation proposal is better than prevailing practices linking compensation principally to reported earnings and stock performance, but it still involves no risk of loss for bankers – only forgone gains – if creditors do poorly. The Langevoort and Johnson proposals make it easier to show management wrongdoing and to impose personal liability, but still turn upon a showing of wrongdoing. The uncertainties and transaction costs of a fault based legal system accompany (and limit) the social benefit derived if the enhanced fault based liability rules do in fact change the way executives behave. If the liability rules do not change the way executives behave because the legal system does not work effectively or because executives are overconfident of their legal position, or for some other reason, the only lasting effect will be more litigation and more excuses made by executives in the course of defending litigation.

None of these proposals go as far as we do in approaching banking as the type of socially useful yet potentially "ultra-hazardous" activity that should involve – as it has involved at times in the past – some measure of strict personal liability. How much strict personal liability there should be, and for whom, is a debatable issue, but we believe there should be some.

We set forth below two proposals for imposing some measure of personal liability on the most highly paid employees of banks and other financial services firms. We will discuss

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[16] See Lucian Bebchuk and , Regulating Bankers Pay, posted on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072

[17] See Donald Langevoort, On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies and the Debate over Entity Versus Individual Liability, 42 Wake Forest Law Review (2007), posted on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072

[18] See Lyman Johnson, Corporate Officer s and the Business Judgment Rule, 60 Business Lawyer (2005), posted on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=711122

the broad parameters of these proposals here. Details will be developed in future publications.

Our core rationale for each of these proposals is that the people who need the most protection are not shareholders, or even creditors, but rather 'the public' – taxpayers who have funded the bailouts, many other people who have suffered from the financial crisis, firms that were careful in controlling risk but still lost money in transactions with firms that were not – a very expansive list. Bankers who profit enormously from their occupations in good times should be prepared to share in the costs borne by the public when the risks they take do not pan out.

Mandatory Partnership/Joint Venture Agreement

The essence of this aspect of our proposal is a joint venture / partnership agreement between a Covered Company, as we define it below, and an employee of a Covered Company who earns exceptionally high compensation from the company. The joint venture / partnership agreement between the employee and the company would exist regardless of the organizational form chosen by the company and the liability rules that normally attach. Indeed, we anticipate that many, if not most, Covered Companies would do business as limited liability entities; the proposed agreement would make some of their employees personally liable for some debts of those companies.

A threshold distinction is between companies that would be covered by the proposal ("Covered Companies") and companies that would not be covered. The objective here is to identify categories of companies for which it would be desirable from a societal perspective for highly paid executives to be personally responsible for company liabilities. The limited liability rule would continue to shield executives of other companies whose organizational form provides limited liability. We initially propose for discussion purposes that the list of Covered Companies include most firms that are federally insured banks or bank holding companies; firms that originate, buy, or sell mortgages; firms registered as broker-dealers or investment advisors under the Securities Exchange Act, and at least the larger hedge funds.

Another important distinction is between those employees of Covered Companies who are covered by the proposal ("Covered Employees") and those who are not. We propose that an appropriate threshold amount would perhaps be $3 million (adjusted for inflation) in annual compensation, where compensation is broadly defined to include, among other things, stock options and phantom stock. There would be anti-abuse rules designed to cover 'creative' ways of structuring compensation to avoid the recipient being a Covered Employee. We recognize that this would include both employees in management positions whose job includes oversight of firm operations and employees such as traders who are principally responsible only for their own work and do not have oversight responsibilities. The case for imposing liability on the first group is the strongest, yet traders and other employees without oversight responsibilities can still have a substantial impact on a firm's attitude toward risk. Making them personally liable for the firm's

debts – as trader partners were in the old investment banking partnerships -- is likely to make the firm's approach decidedly more conservative. For discussion purposes at least, we propose that the personal liability rule extend to all employees earning over the threshold amount, whether or not those employees are technically corporate officers or managers.

Below, we discuss the main features of our proposal, leaving a detailed discussion for our more detailed publication on this subject.

Our proposal would specify the beginning and ending dates of Joint Venture / Partnership Agreements. The beginning date would be fairly easy to specify – in broad brush, from the time the employee became a Covered Employee. The ending date would be harder, as we would want to include some period after the person ceased to be a Covered Employee and indeed, even after the person ceased to be an employee of the company at all. Traditionally, partners who leave general partnership status to become limited partners upon retirement, or who sever their relationship entirely with a partnership, are not liable for debts of the partnership incurred after they are no longer general partners. Nonetheless, many liabilities a firm may incur are based on decisions made at an earlier point in time. We propose that the partnership/joint venture agreement extend for one year after the employee has left the company unless the former employee can demonstrate, in ways we will detail, that he was not involved in the incurrence of the liability at issue (Covered Employees under our proposal would be liable whether or not they were involved in the incurrence of a liability if the liability was incurred while they were Covered Employees)

Our proposal will specify which of a Covered Company's liabilities would be covered by the joint venture / partnership agreement. The main liabilities we mean to cover are those a company would incur because it has taken on financial risk. For instance, many contract liabilities to creditors would be covered, as would tort liabilities under the securities laws, including underwriter liability and liabilities for any type of fraud. [19] Most ordinary tort liabilities would not be covered – we see no policy reason why a 'slip and fall' case should yield liability to a Covered Employee. Nor would ordinary contract liabilities of the sort also incurred by companies that are not Covered Companies, such as pension or health care obligations to employees and retirees, be covered. In these contexts there is little policy rationale for differentiation between Covered Companies and other companies.

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[19] One objection should be anticipated: people may be liable for matters they had 'nothing to do with.' Our response is as follows: The bulk of people subject to our proposal will be high-level managers. While they may be specialized within the firm, they are senior enough in the hierarchy that they are chargeable with the consequences of whatever happens to the firm. Their bonuses may very well relate to overall firm results. In partnerships, a partner couldn't get out of liability by pointing out that he'd had nothing to do with the activity which had generated liability. There may be highly paid people who are not senior managers. While we recognize the objections to having them be liable for something that happened someplace else in the firm, the inquiry into 'whodunit' is one that is important to avoid. Divisions with more clout may be good at making it seem as though the 'mistake' happened someplace else in the firm. And, to the extent managers' personal liability exposure motivates firms to be smaller, that may be a good result.

Yet another crucial issue is what type of event would trigger personal liability of a Covered Employee under the joint venture / partnership agreement (the "Triggering Event"). A bankruptcy filing, liquidation, receivership or government conservatorship of the Covered Company probably should be a Triggering Event. Our proposal will detail what short of such an event might trigger a Covered Employee's personal liability. As is the case in partnership law, the Covered Company's assets -- including any claims it had against counterparties -- would be used to pay off its debts first; only if its debts remain unsatisfied would there be a call on the Covered Employees for contribution of additional amounts to pay the debts of the Covered Company. A basic premise of the Joint Venture/ Partnership Agreement is thus that the Covered Company itself should be primarily liable for its debts and the Covered Employee only stand in the position of a guarantor similar to that of a general partner in a partnership.

A final consideration is whether some of a Covered Employee's assets ought to be exempt from reach by creditors of the Covered Company and if so, how much. Such an exemption would be more generous than the law governing general partners, who ordinarily are only entitled to whatever exemptions of personal property and homestead allowances that bankruptcy law would allow and then only if they personally declare bankruptcy (some states such as Florida have generous homestead allowances, but the humiliation of declaring bankruptcy may be required to take advantage of them). We propose, however, an exemption that would allow a Covered Employee to designate $1 million in personal assets that would not be subject to attachment by creditors of the Covered Company. We also propose to increase this amount somewhat for older Covered Employees; otherwise the mandatory joint venture / partnership agreement could have a disproportionately harsh impact on them because they would not have sufficient opportunity to rebuild their assets after a firm failure. [20]

In the same vein, we also propose to save a Covered Employee from the humiliation and cost of having to declare bankruptcy in order to put future income beyond the reach of firm creditors. We would exempt assets acquired in the future from reach by the Covered Company's creditors. Only assets owned by the Covered Employee at any time prior to the end of the fiscal year in which a Covered Company fails to pay its obligations would be subject to attachment.

There are of course ways around the mandatory partnership/joint venture agreement and any law imposing it would have to plug these loopholes. Covered Companies would have to be barred from obtaining from creditors contractual waivers of managers' personal liability; such agreements would be unenforceable. We will provide more details on these issues in later publications, but the key is to assure the rights of third party beneficiaries of the Covered Employee's obligation, and put such beneficiaries first

[20] Although there are good arguments for increasing, and other good arguments for decreasing, these allowances, we believe they strike the correct balance between requiring a Covered Company's most highly paid employees to have most of their assets at stake in its business and a liability regime that is so draconian that it could discourage executives -- particularly those executives who have accumulated wisdom as well as assets with age -- from working for Covered Companies.

in line to be paid. These rights could not be waived and would consist of a right not only to the amount of money to be paid by the Covered Employee but a right to insist that the Covered Employee be the one to pay that amount without indemnity, insurance or other means of unloading the risk on others.

A more detailed explanation of our proposal will also address asset protection strategies Covered Employees could use to game the system. We will discuss fraudulent conveyance law and other mechanisms by which such strategies would be derailed.

Finally, an obvious way of circumventing the joint venture / partnership agreement would be for senior management of a Covered Company to arrange a government bailout as an alternative to firm failure.[21] Our proposal, without proper safeguards, could even result in political pressure for bailouts that otherwise would not occur. For our proposal to be effective, and not just become a catalyst for yet more government bailouts, bailouts would have to be conditioned upon contribution by Covered Employees of the same capital amount they would have been required to contribute had the firm failed. We will discuss this aspect of our proposal also in future publications.

Assessable Stock

Another way to give some managers some personal liability is to require that some of their compensation be in the form of assessable stock. Nowadays, we are used to stock that is "fully-paid and non-assessable." Lawyers starting practice in the last generation might be excused for recounting the phrase by rote, as pertaining to all stock. But in an earlier era, assessable stock was commonly used, particularly by banks and other corporations that had large numbers of creditors and sometimes urgently needed additional equity capital to survive. Generally the assessment reflected that the stock had been sold at a discount: it was intended to assure that shareholders finished paying for their stock and did not simply walk away if the company's fortunes declined. If the company needed additional capital, consideration not paid for the stock, usually up to its par value, could be assessed by a vote of the board of directors. Depending on its terms, assessable stock could be a significant exception to the limited liability rules that normally comes with the corporate form.

Assessable stock is perhaps well suited to senior investment bankers who today are given stock for which they pay nothing except their services to the company. These lucrative stock packages are acceptable if the company thrives or perhaps even if it only remains

[21] One of us has discussed elsewhere the arbitrariness of government bailouts and the role of political influence of firm managers in obtaining bailouts. See Richard W. Painter, Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab, posted at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1470910

solvent. But if the company becomes insolvent the banker's services should be deemed to be inadequate consideration for the stock. The banker should then be required to pay cash for his stock. As with assessable shares generally, the assessment should be tied to what the stock was worth when it was issued – what would have been paid by a third party purchaser- not the far lower value the stock has once it becomes evident that an assessment is necessary.

Assessable stock is a less severe measure than the unlimited liability of partnership or the personal liability under the joint venture/partnership agreement we describe above. Assessable stock would impose some degree of personal liability on a senior employee in circumstances where the harsher measure of imposing a partnership/joint venture relationship would not be justified. Some employees earning less than $3 million could be required to accept some of their compensation in assessable stock Furthermore, policy makers might not want to impose a partnership/joint venture relationship on even the most highly paid employees of certain companies, but might be willing to require that compensation over a certain amount only be in assessable stock The assessable stock would not be as effective a risk deterrent as the personal liability we describe above, but assessable stock is a half-way measure that might be useful for achieving some of the same desired ends.

The assessable stock that we propose here would be the only permissible medium that could be used to compensate any employee in excess of a certain amount (we suggest $1 million annually) of a financial services firm (we propose using the same definition of a "Covered Company" as for the proposed partnership/joint venture agreement discussed above). Compensation up to this amount, but no more[22], could be paid in cash, non-assessable stock or other consideration; compensation over this amount could only be paid in assessable stock.[23] If both this proposal for assessable stock and our proposal for mandatory partnership/ joint venture were to be implemented, some Covered Employees would also have assessable stock. This would probably be overkill. In any event, as discussed below we propose that the same amount of personal assets ($1 million) be exempt from both the stock assessment and from personal liability. The Covered Employee thus would be entitled to have this much left over after payments made pursuant to both parts of our proposal.

The assessable stock would be nontransferable until one year after the date on which its holder left the employ of the company. The stock would have a par value equal to its

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[22] We would allow firms to pay additional cash compensation in excess of the $1 million to cover income taxes on the value of the assessable shares.

[23] There is no need to define a "covered employee" for the assessable stock version of our proposal because any employee receiving over $1 million (computed taking into account all types of compensation, not just salary) would be paid that excess amount in assessable stock. We do not propose making any exceptions.

book value on the date of issuance – generally the total net assets of the company under GAAP divided by the total number of assessable and non-assessable common shares outstanding. The higher the company's reported net assets on its financial statements the higher the par value of the assessable stock. An alternative would be to set the par value equal to the stock's market value on the date of issue. In either case, the stock would be assessable in an amount equal to its par value. Such an assessment would be a personal obligation of the beneficial owner of the stock with full recourse against personal assets not just against the stock.[24]

For reasons similar to those discussed in the context of a partnership/joint venture agreement, we propose to exempt up to $1 million in personal assets from the assessment. Although assessable stock used in earlier years contained no such exemption for stockholders of limited means, such an exemption avoids the undue hardship which some families still remember from assessable shares held by relatives during the Great Depression. For the reasons explained above, making assets in excess of $1 million subject to the assessment probably imposes sufficient downside risk to encourage prudent management decisions by company executives who hold the stock. Recall in this regard that our aim is far less to create a pot of assets available to 'the public,' but rather, to put the brakes on excessive risk-taking.

The incentives created by this version of our proposal are somewhat different from those created by the proposed mandatory partnership/joint venture agreement. The partnership/joint venture agreement is an on-off switch that turns on when a Covered Employee earns over $3 million per year. The assessable shares gradually phase in personal liability depending on the amount of accumulated annual compensation over $1 million per year. The longer an employee has been with the company accumulating stock the more personal liability exposure that employee has. The most senior employees are likely to pay the most, although some less senior employees who have been with the company accumulating stock for a long time would pay a lot as well.

The assessable stock also would potentially leave some personal assets, in some situations a lot of personal assets, in excess of $1 million intact because the assessment would be capped at the par value of the stock[25]

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[24] One year after an employee left the company, the company could exchange non-assessable stock for the assessable stock (it is contemplated that most employment agreements would probably require the company to make the exchange although the company could insert a provision cancelling the exchange if the board of directors finds that the former employee acted negligently in the course of his or her employment with the company).

[25] Making the assessment several times par value but only requiring the assessable stock to be used only for compensation in excess of $3 million would make the assessable stock proposal closer to our

The assessable stock proposal has the added benefit of discouraging senior executives from inflating the reported value of net assets on company balance sheets. If the assessment is tied to the stock's par value and this in turn is tied to its book value, the incentive would be to state net assets conservatively. A par value and potential assessment tied to the stock's market value on the date of issue also would discourage executives from engaging in accounting gimmicks and other practices that inflate stock price. No longer would "mark to market" accounting be supplanted by phony "mark to bonus" accounting that overstates company profits and justify gigantic paydays.

There are many variations on both this assessable stock proposal and the mandatory partnership/joint venture agreement proposal that we will explore in a future article. Each of these vehicles can be designed to impose more or less personal liability on more people or fewer people. Depending on these and other variables the incentives – good and bad – created by each can be manipulated to achieve a mix between prudence and willingness to take reasoned risks. Our objective here is to begin discussion of these possible arrangements for imposing personal liability and what they might mean to the future of the investment banking industry.

Possible Objections to the Proposals, and Our Responses

There will be objections to our proposal, some more serious than others.

First, U.S, regulations imposing some personal liability could make it difficult for U.S. investment banks and other Covered Companies to get some employees, and make it more likely that such companies lose some employees to foreign competitors. Implementing some version of personal liability in several of the world's leading financial centers thus might be more successful than implementing personal liability only in one place, even a place as large as the U.S. Some of these arguments against unilateral regulation, however, could be overblown (Wall Street's competitive position is raised as an argument against just about every regulatory proposal, including Sarbanes-Oxley in 2002 and proposals now being considered in response to the latest failure of unregulated financial markets). Many people are willing to pay significant amounts to live or work in particular places (New York has much higher taxes than New Jersey, yet many yet people who could commute from New Jersey live in New York). A place with some version of personal liability also might be a safer place to work as an investment banker because other investment bankers will be more careful (while some drivers prefer

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partnership/joint venture agreement proposal. The personal liability would be more severe but it would extend to fewer people.

the autobahn, not everyone objects to driving a car in a place with a speed limit). Investment bankers and others in the financial markets thus may be willing to assume the risks of some personal liability in order to enjoy the financial and other benefits from being able to ply their trade in their country of choice.

Second, personal liability could discourage some persons, particular those who have acquired significant assets as well as experience, from remaining in the investment banking business. The old investment banking partnerships did not seem to have this problem. Nonetheless, we recognize that our proposal should mitigate this problem by shielding from firm creditors sufficient personal assets to allow an executive a comfortable retirement even if his or her firm fails ($1 to $2 million, adjusted for inflation, might be an appropriate amount). Partnerships of old did not offer this type of asset protection, but limited asset protection is not inconsistent with our intent to impose enough downside on highly paid investment bankers to discourage excessive risk. The threat of genuine poverty might have popular appeal but is not required. Relative poverty should suffice.

Third, investment bankers might try to evade personal liability through insurance or other contractual arrangements. Executives could ask for a “firm failure” rider to directors and officers’ insurance. Although executives cannot themselves legally short their company’s stock to hedge against firm failure, they could encourage family members to do so. Some of these strategies could be regulated – for example by making firm-failure liability insurance contracts legally unenforceable – while other strategies might avoid regulation. The old investment banking partnerships also saw their share of contractual arrangements that shielded partners from firm debts (family trust funds sometimes served this purpose and Goldman Sachs, which did not become a corporation until 1999, did some of its business through limited liability entities controlled by the partnership). The point here, however, is not to eliminate every avenue of personal asset protection in the event of firm failure. Compensation of firm creditors is of secondary importance (personal assets of firm managers are likely to be a small portion of the amount needed to pay off creditors). The point is deterrence of excessive risk. Our proposal should require a sufficient number of the top decision makers at a sufficient number of firms to have enough of their financial well-being on the line to make a difference in the risks they take with other people’s money. The direction in which the herd of investment bankers is headed should change with exposure to personal liability; excessive risk takers will stand out from the herd instead of leading everyone else over the precipice.

Finally, personal liability may discourage some innovation in developing new financial products (the old investment banking partnerships developed some new financial

products such as zero coupon bonds, but financial services innovation took off in the 1980s). This is a genuine concern from the standpoint of global competitiveness.

To overstate our position for a moment: perhaps in the financial services area we have had enough innovation for the time being. We do not need more new products that investors don't understand, particularly when so many investors are institutions run by managers who respond not by shunning unfamiliar products but instead by succumbing to a herd mentality of doing whatever other investors do. Innovations scarcely warrant the favorable connotation that term carries in an atmosphere where investors – many playing with money that is not their own -- refuse to admit that they don't understand them. To state our position more moderately, we think financial innovation is overrated, and can be quite perilous, especially where people making many of the relevant decisions are, contrary to what many economists believe, people who suffer from many behavioral foibles. In this regard, one of us has argued that rating agency employees were vulnerable to a 'if you don't see how great this instrument is, it's because you're too stupid to understand it' pitch. We would note, too, that in other fields, such as the development of pharmaceuticals, we are quite willing to tolerate rules and policies that may interfere with innovation. To the claim that in the pharmaceuticals field the stakes are higher, the current crisis is evidence enough that financial snake oil also has an enormous social cost.