

## Business Associations I

Prof. Aviram

### **Simulation 1: Employee Incentives (The Agency Problem)**

[Real world note: The two enclosed reports are real articles. The one about Merrill Lynch is from the Financial Times, January 19, 2008, p. 1; the one about UBS is from the Wall Street Journal, August 22, 2008, p. C14.]

**From:** Wendy I. Zeller [mailto:Ms.WIZ@work.com]

**Sent:** Friday, July 25, 2008 4:25 PM

**To:** WIZ Team Mailing List

**Subject:** CONFIDENTIAL – WidgetWorks

Team:

Our client, WidgetWorks, Inc., is a Delaware Corporation that is NOT publicly traded. It has about a dozen shareholders, with 52% of shares owned by founder Patricia Gizmo and her relatives, and the other 48% owned by five venture capital firms.

WidgetWorks has three lines of business: Widget Production, which is done in widget factories owned by the company.; Trading in Widget futures, which involves complex financial transactions (essentially betting on the future price of Widgets); and Consulting, which involves assisting purchasers of Widgets in finding new and innovative ways to use Widgets in their products (which leads to those companies purchasing more Widgets from WidgetWorks).

WidgetWorks has asked us to evaluate options for improving its employee incentive program. Currently, WidgetWorks' incentive program works as follows: The board of directors decides what percentage of last year's profits goes into the general bonus pool. The CEO (Patricia Gizmo) then divides that pool of money into three divisional pools – one for each of the company's three lines of business. She has full discretion as to how to divide the money, and does so based on her subjective assessment of how close each division's profits came to what she believes is the division's profit potential. The head of each division then takes their divisional bonus pool and determines, based on his/her discretion, how much of a bonus (if any) each employee in the division would receive. The total bonuses awarded cannot exceed the amount in their bonus pool.

Ms. Gizmo feels that this system is not properly incentivizing the employees. She sent me reports on two incentive plans considered by other companies: Merrill Lynch and UBS. She wants us to consider these, but also other options, and suggest to her several alternatives for a new employee incentive programs, explaining the advantages and disadvantages of each.

I'd like you to prepare the first draft of our memo to WidgetWorks. As you identify promising alternatives, please identify potential problems/disadvantages, and fine-tune the program to try and minimize the disadvantages. Please describe your suggestions in great detail (e.g., not just suggesting the use of stock options, but specifying how much, at what price, who decides these things, can they be traded, when can they be exercised, etc.).

Please e-mail that first draft to my assistant, at: [aviram@illinois.edu](mailto:aviram@illinois.edu).

Thanks!

# Merrill to reform bonus system

Thain labels current situation 'impossible'

Pay-out to be based more on overall success

By Ben White in New York and Chris Hughes in London

The new chief of Merrill Lynch has promised to overhaul the firm's bonus system after Wall Street banks made record pay-

outs in spite of huge losses. John Thain, Merrill Lynch's chief executive, said the discrepancy between performance and compensation had been caused by "basically an impossible situation".

"Most of our businesses had very good or record years. The huge losses were created by a small number of people," he said.

Mr Thain planned to change the bank's pay system so that it was "based more on how the whole company did; then on how

the individual business did; then [on] how the individual did".

Bonuses at the five largest investment banks rose to a high of \$40bn last year, up from \$36bn the previous year, even as they reported more than that in combined mortgage-related asset writedowns.

Shareholder activists say the structure of Wall Street compensation needs to be changed.

One bank executive said the pay-outs risked raising tensions between management and share-

holders when investors in banks have seen their stakes diluted by cash injections elsewhere.

The bonuses have caused consternation at banks that have escaped big losses. Employees want to know why their bonuses were not higher than those paid at rival firms that lost money.

Mr Thain's move may influence peers in Europe who are facing similar pressures as they finalise this year's bonus round.

"We are trying to maintain discipline, and that is not easy to do

when others are letting their compensation ratios jump up," said one European investment bank executive.

Banks largely base bonuses on individual performance, meaning that pay declines have been borne by a small number of fixed-income bankers and traders responsible for the bulk of the year's losses.

At most banks, divisions such as equities, asset management and merger advisory performed well, leading to higher bonuses.

The five largest investment banks - Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers and Bear Stearns - paid out about \$66bn in compensation in 2007, including an estimated \$40bn in bonuses. The average bonus figure last year was \$180,420, down about 5 per cent from the previous year, according to Thomas DiNapoli, New York state comptroller.

## UBS Seeks New Incentives

*'Phantom Equity' Gives Employees Rewards Tied To Their Specific Businesses*

Could "phantom equity" be the solution to the problem of how to incentivize people working for financial supermarkets? UBS thinks it might be.

The Swiss bank consists of a wealth-management unit, an investment bank and an asset-management arm. At present, employees receive a large chunk of their remuneration in the form of UBS stock. That is a blunt motivational tool. If the investment bankers mess up—as they did with their credit-bubble bets—it drags down the value of everybody's shares. Equally, if the private-wealth unit gets into trouble—as it has over allegedly helping U.S. citizens evade tax—the investment bankers suffer.

One alternative, which UBS is considering, is to give everybody "phantom equity" in their respective business units. That way, their rewards would be more closely tied to how well their specific businesses perform. They would even have an incentive to stop their colleagues from doing foolish things. The idea is appealing, in theory. It could even be a model for other financial supermarkets. But UBS will have to answer a key question before this idea can fly: How to value the phantom shares?

The obvious starting point would be to value each business by putting its earnings on an appropriate price-earnings multiple. The snag is that, if you do that today, the value of the wealth-management unit and the asset-management business add up to more than the bombed-out stock market value for the entire company. In other words, the investment bank would have negative value. Mind you, the investment bankers themselves might not mind that. If they received very cheap phantom

stock, they could be in line for a windfall when markets rebound. There are ways around this problem—like applying discounts to all three phantom shares to bring the sum of them into line with the market price. But that would underline just how little the market likes UBS's financial-supermarket business model. Ultimately, it might be better to break the company up and give employees plain, rather than phantom, equity.