Lectures for Adverse Selection and Moral Hazard

**Asymmetric Information** – a situation that exist when some people have better information than others.

2 Types:
**Hidden Characteristics** – things one party to a transaction knows about itself but which are unknown by the other party.

**Hidden Action** – actions taken by one party in a relationship that cannot be observed by the other party.

### I. ADVERSE SELECTION:

Situation where individuals have hidden characteristics and in which a selection process results in a pool of individuals with undesirable characteristics.

**Problem 1:** The used car market for 1990 Honda Civics consists of 300 sellers and many, many buyers. 200 of the sellers have “lemons” (cars they have not taken care of very well) and 100 of the sellers have “peaches” (cars they have taken care of). All sellers with lemons have a reservation value of $1,000 and all sellers with peaches have a reservation value of $2,500. The maximum buyers are willing to pay for a 1990 Honda Civic if they know it is a lemon is $2,000 and the maximum buyers are willing to pay for a 1990 Honda Civic if they know it is a peach is $3,000.

a) Perfect Information (Sellers and Buyers can differentiate between lemons and peaches)

![Graph of Lemons and Peaches](image-url)
b) Private Information (Sellers can differentiate and Buyers can not differentiate between lemons and peaches)

http://autopedia.com/html/LemonLaw/Michigan_MI_lemonlaw2.html

Assume that the Buyers are risk neutral.

![Graph of supply and demand for nannies](image)

**Problem 2:**

Mike Conlin and Stacy Dickert-Conlin live in East Lansing and are currently looking for a nanny for their son Charlie. Suppose two different types of nannies exist in East Lansing. Type G is a good nanny who will play with Charlie and Type B is a bad nanny who will watch Jerry Springer with Charlie. There are forty good nannies and sixty bad nannies. All good nannies have a reservation value of $25,000 per year and all bad nannies have a reservation value of $15,000 per year. (Therefore, the good nannies are not willing to work as a nanny for less than $25,000 per year and the bad nannies are not willing to work as a nanny for less than $15,000 per year. Perhaps the reason good nannies have a higher reservation value is because they can obtain jobs as teachers or at day care facilities.)

All potential employers of nannies in East Lansing are willing to pay $30,000 for a good nanny and $20,000 for a bad nanny. Assume there are thousands of risk-neutral potential employers of nannies who cannot differentiate between a good nanny and a bad nanny, but they know that there are forty good nannies and sixty bad nannies.

Depict the supply and demand curves for nannies on the graph below. In equilibrium, how many nannies are employed in East Lansing and how much are they paid? SHOW CALCULATIONS.
Why do parents adopt so many girls?

The evidence suggests that fathers prefer boys over girls. For instance a couple is more likely to stay married when they have a boy rather than a girl. Here is my earlier summary of the research.

At the same time couples are far more likely to adopt girls rather than boys? How can this be?

A recent Slate article offers some figures:

Numbers vary, but it's pretty safe to say that somewhere between 70 percent and 90 percent of parents looking to adopt register some preference for a girl with an agency. It doesn't matter if they're adopting from China, where girls far outnumber boys; from Russia, where the numbers are about even; or from Cambodia, where there is typically a glut of orphan boys and a paucity of girls. Everywhere, demand tends to favor the feminine.

Steven Landsburg had suggested an adverse selection argument. Yes boys are favored but if a boy is put up for adoption, you can figure there is something wrong with the boy, for precisely that reason.

Or perhaps it is easier to nurture girls, and the nurturing motive may be central to the adoption decision. It also may be the case that mothers prefer girls and mothers also drive adoptions:

"The extent to which women are the driving force in most adoptions is probably a factor," he says. "It's usually true that the women are filling out the paperwork, going to the conferences, the support groups." He adds, "If I speak at a conference—whether it's on adoption or family issues—at least 80 to 90 percent of any of these audiences are women."

My take: Having a boy is a riskier investment than having a girl. The risk rises dramatically with adoptions, given the associated genetic uncertainty. Males are more likely to have genetic roots for criminality and mental illness. So if you don't know much about the parents, better to play it safe and opt for a girl.
II. MORAL HAZARD:

Situation where one party to a (potential) transaction takes a hidden action that benefits him or her at the expense of another party.

EXAMPLE 1: Firm Selecting to Produce High or Low Quality Good

i) Firm Chooses to Produce Low Quality Good and Consumers are aware that it is a low quality good. When producing a low quality good, the firm has constant marginal cost of 20 and total fixed costs of 100.
ii) Firm Chooses to Produce High Quality Good and Consumers are aware that it is a high quality good. When producing a high quality good, the firm has constant marginal cost of 20 and total fixed costs of 150.

WHAT IF CONSUMERS CANNOT DIFFERENTIATE A HIGH QUALITY FROM A LOW QUALITY GOOD PRIOR TO PURCHASING THE GOOD?

Problem 2:
Suppose you own Starbucks Coffee and live in Seattle, Washington. You are deciding the compensation to offer Fred Orangeman, the manager of your store next to Michigan State University. Suppose Fred can work 40 hours a week or 60 hours a week. Fred’s opportunity cost of working the additional 20 hours a week (from 40 hours to 60 hours) is $20,000 per year. Also, suppose Fred can obtain a job at Brueger’s Bagels where he works 40 hours a week and that job pays $40,000 per year. (Assume that Fred is indifferent between a job at Brueger’s Bagels and managing the Starbucks if the compensation and hours are the same.)

You are far too busy to monitor whether Fred is working 40 hours a week or 60 hours a week but you do observe the store’s revenue. You know that total annual revenue from the Starbucks next to SU is likely to be higher if Fred works 60 hours a week. Assume that total annual revenue from the store is either $100,000 or $200,000. If Fred works 40 hours a week, total revenue will be $100,000 with probability .6 and $200,000 with probability .4. If Fred works 60 hours a week, total revenue will be $100,000 with probability .2 and $200,000 with probability .8. (Basically, Fred working more hours increases the probability that revenue will be $200,000 rather than $100,000.)

a) If you pay Fred a wage of $40,000, what would be your expected profits from the store next to MSU? Assume that your only cost is Fred’s wage. Show Calculations and Explain.

b) How can you structure Fred’s contract to induce him to work 60 hours a week? (Don’t provide numbers, just explain the intuition.)

c) What is the optimal contract to offer Fred in order to maximize your expected profits from the store? Assume that Fred is risk-neutral and that your only cost is Fred’s wage. Show Calculations and Explain.
The sharp rise in executive compensation perplexes corporate governance experts who expected temperance following scandals at Enron, WorldCom and Tyco, increasing scrutiny by regulators and shareholder activists, and starting this year, new accounting rules requiring expensing of stock options.

"Corporate boards are under more pressure to ensure there's a linkage to performance and shareholder returns, but they'll still be looking for ways to maximize pay packages to stay competitive," says Carol Bowie, head of governance research at proxy adviser Institutional Shareholder Services.

One of 2005's largest windfalls so far among those reported during this proxy season came not to a CEO, but to Omid Kordestani, head of global sales at Internet search engine Google. He exercised stock options for a $287.9 million gain. Neither Kordestani, 42, nor Google responded to calls.

Google CEO Eric Schmidt and co-founders Sergey Brin and Larry Page — who requested in 2004 that their salaries be reduced to $1 and refused 2006 raises — exercised no options. But they own big Google stakes; Brin and Page each own stock worth about $12.5 billion.

Another huge payout came to Analog Devices CEO Jerald Fishman, who cashed out $144.7 million from his deferred compensation plan and made another $4.3 million in salary, bonus and options gains.
• 3M's James McNerney, who replaced Boeing CEO Harry Stonecipher in June, received $25.3 million in Boeing stock to compensate him for losing potential payouts at 3M. His last six months at 3M proved lucrative, too. He got almost $41 million — $8.4 million in compensation and $32.4 million exercising 3M stock options. There was no golden parachute for Stonecipher, forced out after the revelation of an affair with a subordinate. But Stonecipher made $39.5 million, including $11 million in incentive pay and $26.9 million exercising stock options.

• John Mack, who replaced ousted Morgan Stanley chief Philip Purcell in June, pulled in more than $68 million, including $37.8 million in restricted stock and $30 million exercising stock options.

Purcell's golden parachute was valued at about $52 million, including a $44 million bonus.

Morgan Stanley co-president Stephen Crawford, who also left, received a settlement worth $36 million.

Such payouts — whose key provisions are largely negotiated as part of employment contracts — have become boilerplate as corporate boards agree to lucrative retention agreements designed to prevent CEO "flight risk," says Ira Kay of pay consultant Watson Wyatt and author of Myths and Realities of Executive Compensation, due out later this year.

"It's a seller's market, and executives have real market power," Kay says. "Most directors are as obsessed with retaining their CEOs as they are satisfying shareholders. Directors know if they have the right team in place, they have to do whatever they can to retain it."

Most compensation advisers and corporate governance experts doubt a Securities and Exchange Commission proposal requiring boards to provide more clarity, justification and disclosure about pay, perks and supplemental retirement will curb CEO pay. "You'll still see extraordinarily egregious deals going down," says Bowie.

New accounting rules that require companies to expense stock options beginning this year aren't likely to limit new option grants to CEOs, either.

"We'll see fewer options granted to lower and middle management employees, but there'll be no effect on option grants to CEOs," says John England, who advises directors for compensation consultant Towers Perrin. "Most directors still believe options are an important piece of senior management's compensation."

Boards are under more scrutiny from shareholders and regulators. Bowie says shareholders will vote on nearly 150 proposals aimed at making boards more accountable. Measures include director term limits, annual elections and provisions to remove directors receiving less than 50% of votes cast by shareholders.

There are about as many ballot measures regarding directors as are being floated to curb CEO pay. Yet, most resolutions are non-binding and ignored by directors, even those overwhelmingly approved by shareholders. Most companies oppose provisions such as annual director elections, which tend to make boards less insular and beholden to management.

Some reformers believe fundamental changes in the way CEOs are compensated won't occur until corporate directors are held more accountable. "They're not sufficiently dependent on shareholders, who lack real power to remove them from boards," says Harvard University professor Lucian Bebchuk, who decries the lack of connection between pay and performance and is pushing for bylaw changes at several firms.

Increased shareholder activism is putting more pressure on some boards to weigh compensation practices, such as covering CEOs' income taxes, more closely, says Temin & Co. pay consultant Bruce Ellig, author of The Complete Guide to Executive Compensation.

Moreover, some boards have begun acquiescing to investor pressure. Prompted by the Teamsters union, Coca-Cola said it would seek shareholder approval of future executive severance packages. The move comes after the soft-drink giant fitted former CEO Douglas Ivester with a golden parachute worth $119 million after four years and successor Douglas Daft, who lasted three, $36 million in severance.

Other companies are already providing more extensive compensation disclosure to shareholders, and board advisers say there's far more backroom discussion among directors about CEO pay.

"There's a change that outsiders wouldn't see — directors asking about the cost implications, disclosure implications, what could go wrong with a plan that pays too much for performance that isn't justified," says England. "Board members are saying they don't want their reputation besmirched."

Overcompensating?

For now, among many corporate boards, looking to enhance pay for already handsomely compensated CEOs remains the norm.
United Technologies' George David has made nearly $300 million in compensation since he became CEO in 1994, including about $40 million in salary and bonuses and more than $250 million from stock option gains, according to SEC filings. He holds exercisable options valued at $138 million. Directors boosted his salary 42% to $1.7 million in 2005, saying it was his first raise since 1998, and awarded fresh options valued at $24 million.

Directors cited his long tenure, leadership, an *Institutional Investor* magazine survey ranking him tops among his aerospace and defense electronics industry peers and the company's "exceptional" performance. Most longtime shareholders might not quibble: They've gained about 18% annually under David.

"We can all argue how we value CEOs and if their pay makes sense," says Alan Johnson, a principal in compensation consultant Johnson Associates. "But we chronically overvalue CEOs. Until that's addressed, higher pay will continue."

At poor-performing companies, some boards are ignoring performance guidelines to reward executives. Sun Microsystems, down more than 90% from its 2000 peak, gave CEO Scott McNealy a $1.1 million "discretionary" bonus last year, even though Sun failed to meet income or earnings targets. The board cited a "one-time need" to recognize McNealy's performance. McNealy gained $11.8 million exercising options. Already Sun's largest individual shareholder, McNealy also received fresh options worth $7.6 million.

"There's a point where a board should tell the CEO, 'You have enough to incentivize you,' " says Paul Hodgson, pay analyst for The Corporate Library, a governance watchdog group. "But it's still business as usual at most companies. It's all about keeping up with the Joneses. There's still a disconnect between paying for performance and actually delivering it. There's no shame factor."

How the USA's largest companies compensate their chief executives. In addition to salary, bonuses and gains from stock options exercised, total compensation includes restricted stock, long-term incentive payments and the potential value of stock options. Definitions can be found below the chart.

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WASHINGTON — When Mark Key crashed his motorcycle in downtown Louisville on July 23, 2002, he wasn't wearing a helmet. His head injuries were so severe that doctors told his wife, Monica, to prepare for the worst. "Two doctors predicted to her, 'Don't look for him to make it tonight,'" Key said. He was told later. But Key survived, just missing becoming one of the rising number of motorcycle deaths in Kentucky since the state's mandatory helmet law was repealed in 1998. Motorcycle deaths increased by 58 percent in the two years after the helmet law was scrapped, and use of helmets quickly dropped, according to a study released Tuesday by the National Highway Traffic Safety Administration. The study focused on Kentucky and Louisiana, which repealed its helmet law in 1999. In that state, motorcycle deaths soared by 111 percent in the two years after repeal, the study said. "The findings aren't any surprise," said traffic agency spokesman Rae Tyson. "It's pretty consistent with what we see whenever a state repeals its helmet law." Helmet law opponents, however, disputed the findings. "What they have failed to take into account is the increased number of riders in the state," said Jay Huber of Union, Ky., president of the Kentuckiana Motorcycle Association. Huber also said deaths on motorcycles can't be attributed to whether a rider used a helmet. He said his examination of the statistics showed that half of those killed on motorcycles wore helmets. The federal study, however, said the rate of fatalities per motorcycle registration in Kentucky increased 37 percent, faster than the increase in the number of registrations, which was 20 percent. The national fatality rate, based on the number of riders killed per 10,000 registered motorcycles, was 6.3 in 2000, compared with 8.2 in Kentucky. The study did not include 2001 or 2002, but figures obtained from the traffic safety administration show that Kentucky's motorcycle fatality rate increased to 12.77 in 2001.

INDIANA, WHICH repealed its mandatory helmet law in 1977, had a 2001 fatality rate of 5.89. As of 2000, 44,003 motorcycles were registered in Indiana, according to administration data, up from 39,903 in 1998 and 36,603 in 1996. Indiana had 118,000 registered motorcycles in 2000, up from 97,000 in 1996. "More people are getting involved in motorcycling," Tyson said. "But even taking that into account, we can't help but believe there is some correlation between a state repealing its helmet laws and the increase in fatalities." The federal study said that crash statistics showed motorcycle accidents involving deaths and injuries went up after the helmet law was repealed. For example, in 1997, the year before the repeal, there were 24 motorcycle fatalities and 695 injuries. In 1999, the year after the repeal, there were 40 motorcycle deaths and 934 injuries. Helmet use in Kentucky changed dramatically after the repeal, the study said. Before the change, 96 percent of motorcycle riders used helmets. In 1999, the number dropped to 65 percent. Kentucky had passed its helmet law in 1968. But in July 1998, Sen. Dan Seum, R-Louisville, sponsored legislation to repeal it for people 21 and older.

WHETHER TO wear a helmet should be left to "adults making decisions on their own," Seum said. He said he hadn't seen the new federal study but added, "most of the time, those things are pretty self-serving." But Rep. Mary Lou Marzian, D-Louisville, expects to propose legislation for the 2004 General Assembly that would restore Kentucky's helmet law. The new study, she said, "will be very beneficial in hopefully convincing my colleagues that the lives of Kentuckians can be saved with a very simple mechanism, and that's wearing a helmet." Kentucky's repeal has been part of a national trend. In 1975, 47 states and the District of Columbia had helmet laws, which Congress had encouraged by threatening to cut federal highway aid for states that refused to go along. But lawmakers that year ended the threat, and half the states subsequently repealed or amended their helmet laws. Indiana, which had enacted a helmet law in 1967, repealed it in 1977 but in 1985 required helmets for riders under 18. Congress enacted new laws to encourage helmet use in the early 1990s, but then abandoned the idea again. More states repealed their laws, and now only 19 states and the District of Columbia still have sweeping helmet-use laws.

REPEALING THE helmet law was a huge mistake, Key said. "I would vote on (reinstating) it ASAP," he said. His injuries required three weeks in the hospital and six months at a rehabilitation facility, plus six more months of daily visits for additional rehabilitation. Key said he couldn't remember the accident and couldn't remember people. Gradually that improved, but he lost his floor-care business. "It's been rough, but I'm doing OK," Key said. The 40-year-old Middletown, Ky., resident ended his rehabilitation on Oct. 10, and received his new driver's license last Friday. But he's done with motorcycles. "Never again," he said. When he sold his Harley-Davidson, he told the couple buying it he would not go through with the deal unless they purchased helmets. They left to buy them, then came back to pick up the bike. Key, whose wife owns an advertising company, is thinking of going to college and becoming a teacher. His insurance covered his bills; he has no idea what the total came to. He tells friends who still ride motorcycles to wear helmets. "They listen, but I can tell they are barely listening," Key said. Phil Capito, a 44-year-old computer analyst in Louisville who rides a Kawasaki KZ1000, said he doesn't support reinstating the helmet law, but uses one himself.

"I BELIEVE IT'S a personal choice," he said. "... I've been riding 37 years. I was basically brought up on a motorcycle. I never rode one without a helmet." He believes the helmet provides some measure of protection, though he's never had to find out. On the other hand, Capito said he once saw an accident in which the motorcyclist was wearing a helmet and died anyway. Chris Kern, 27, of Sellersburg, Ind., a detail manager at a body shop, said he rides his Suzuki Katana with his helmet on "about 25 percent of the time." The helmet may protect him in some crashes, he said, but the government should not make him wear it. "There's a sense of freedom without the helmet on," Kern said. Huber of the Kentuckiana Motorcycle Association said helmets "can have good and bad effects." They can protect in some crashes, he said, but also can inhibit the motorcyclist's vision, impair hearing, and in warm weather produce heat stress. "It's a freedom issue as well. Does the government need to be playing nanny to us?" Huber said. If others have to pay for that freedom, the answer is yes, said Dr. Todd Vitaz, assistant professor of neurologic surgery at University Hospital in Louisville and co-director of the hospital's Neurosciences Intensive Care Unit. Vitaz was one of the authors of a study released last June that found motorcyclists who didn't wear helmets were more than four times as likely to suffer severe brain injuries as those who used helmets.

BETWEEN 1995 and 2000, motorcyclists without helmets who were treated at University Hospital ran up acute-care charges totaling more than $1.97 million, Vitaz found. The costs did not include physicians' fees, rehabilitation and lost time from work. "Why should society pay for their freedom" not to wear helmets, Vitaz said. "That's a significant burden." Marzian agreed. "If they don't want to wear their motorcycle helmets, don't ask the taxpayers to foot the bill," she said.
Coach Mark J. Dantonio – Employment Agreement Key Terms

1. Agreement effective November 27, 2006 for a rolling five year term.

2. Annual base salary of $600,000, and annual supplemental income (TV/radio, apparel/footwear, and personal appearances) of $500,000, for total guaranteed annual compensation of $1.1 million.

3. Bonus compensation:
   
a. Bowl Game/National Championship (Non-cumulative – no more than one will be paid)
      - BCS National Championship $375,000
      - BCS Championship Game $300,000
      - BCS Non-Championship Game $250,000
      - Non-BCS Big Ten #2 or #3 Bowl $125,000
      - Any other Bowl Game $75,000

b. Win Big Ten Conference Championship $100,000

c. Coach Honors (Cumulative)
   - National Coach of the Year / AFCA $50,000
   - Big Ten Conference Coach of the Year $25,000

d. Graduation Rate – to be negotiated after evaluation at a future date.

e. Academic Progress Rate (APR) (Non-cumulative)
   - 991-1000 $100,000
   - 975-990 $50,000
   - 950-974 $40,000
   - 925-949 $25,000

4. MSU will pay Coach a one time signing bonus of $200,000 (to assist in payment by Coach of liquidated damages owed to former employer and other transition expenses).
5. Coach must seek MSU’s permission before interviewing for other coaching positions. If Coach terminates agreement to take another position coaching in college or in professional football, he shall pay MSU liquidated damages as follows:

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<tr>
<th>Notice</th>
<th>Liquidated Damages (Non-cumulative)</th>
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6. If MSU terminates the agreement at will, MSU must pay the Coach liquidated damages as follows:

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