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Treasury Ties Bailout Funds to Limits on Executive Pay

In October 2008, Treasury announced that it would make capital investments in financial institutions in order to stabilize the financial system. The Capital Purchase Program included limited restrictions on executive compensation for participating financial institutions.[1] On February 4, 2009, Treasury announced a new set of executive compensation guidelines applicable to companies receiving government funds.[2] This announcement comes on the heels of an increasing number of press reports and public outcries over excesses at bailed out institutions. A lavish retreat for AIG employees angered politicians and the public alike. According to Congressman Mark Souder, the AIG retreat represented "unbridled greed."[3] In late fall, in response to growing pressure from politicians and the public, executives at many of the world's largest financial institutions announced they would forego their 2008 bonuses.[4] Finally, in early 2009, amidst controversy over planned purchases of corporate jets, stadium sponsorships, lavish office renovations and employee conferences in "sinful" destinations like Las Vegas, the government took action. Realizing that the existing compensation limitations were inadequate to quell public upset, required too few limitations on the use of public funds and, according to President Obama, a growing sense that "executives [are] being rewarded for failure," Treasury announced extensive prohibitions on executive compensation.

The new guidelines only apply to financial institutions that receive government assistance to address the current financial crisis. The guidelines are not retroactive. The guidelines distinguish between those institutions that receive "exceptional financial recovery assistance" and those that participate in any generally available capital access program. The new guidelines are intended to "ensure that the compensation of top executives in the financial community is closely aligned not only with the interests of shareholders and financial institutions, but with the taxpayers providing assistance to those companies."

Financial Institutions Receiving "Exceptional Financial Recovery Assistance"

The new guidelines provide that senior executives may not receive more than $500,000 total annual compensation. Any additional compensation for senior executives in excess of the $500,000 limit must be made in restricted stock or similar long-term incentive arrangements, and the restricted stock cannot be cashed in until (1) the company has repaid the government (including repayment of the contractual dividend payments accruing on Treasury securities) or (2) after a specified period according to factors such as the degree to which the company has repaid the government, protected taxpayer interests, and met lending and stability standards.

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[1] For a summary of the executive compensation limitations contained in the original Capital Purchase Program, please see our alert at http://www.mofo.com/news/updates/files/14549.html.
[2] See Treasury's release, *available at* http://www.treasury.gov/press/releases/tg15.htm.
[3] Brian Ross and Tom Shine, *After the Bailout, AIG Execs Head to California Resort,* ABC News *available at* http://abcnews.go.com/Blotter/Story?id=5973452.
[4] *Wall Street Firms Pressured to Forego 2008 Bonuses*, CNBC.com *available at* http://www.cnbc.com/id/27788429.

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Many investors in companies from Coca-Cola to IBM already have requested a so-called “say on pay” for shareholders. Consistent with these “say on pay” proposals, the guidelines require that a company receiving exceptional assistance must submit both the senior executive pay structure and an explanation of how compensation is tied to “sound risk management” to a non-binding shareholder resolution.

Unlike with previous exceptional assistance programs, such as those for Citi, AIG and Bank of America, which only provide for a clawback for the top five senior executives, these guidelines impose a clawback for the next twenty senior executives as well. The company must implement provisions to claw back bonuses and incentive compensation from these executives if the executives are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive compensation.

The guidelines also expand the ban on golden parachutes for senior executives from the top five senior executives to the top ten senior executives. In addition, the next twenty-five executives are prohibited under the guidelines from receiving any golden parachute payment greater than one year’s compensation.

Finally, in a move that seems pulled from the headlines, the guidelines require the board of directors of the institution to adopt a luxury expenditures policy. The policy must be company-wide and address expenditures for aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. In addition, the chief executive officer must provide a certification for expenditures that could be viewed as excessive or luxury expenditures. Treasury notes, however, that the policy is not intended to cover reasonable expenditures and measures tied to the company’s normal business operations, including sales conferences, staff development, and reasonable performance incentives. However, there are no objective guidelines that might help distinguish which expenses could be viewed as “excessive or luxury expenditures.” As with most subjective determinations, it is all in the eye of the beholder and lately the beholders (American taxpayers) are outraged by expenses that they view as lavish.

Guidelines for Generally Available Capital Access Program

Unlike the guidelines discussed above, the guidelines for generally available capital access programs are only proposals at this time, and will be subject to a short public comment period. The proposed guidelines limit total senior executive annual compensation to a cap of $500,000, plus restricted stock. However, this provision may be waived by fully disclosing the compensation arrangements and, if requested, a non-binding “say on pay” shareholder resolution. Any firm participating in a future capital access program must review and disclose the reasons why the senior executive and other employee compensation arrangements do not encourage “excessive and unnecessary risk taking.” The guidelines impose on these companies the same clawback provisions applicable to companies receiving exceptional assistance – they are applicable to the top twenty-five senior executives.

In addition, the top five senior executives may not receive any golden parachute payment greater than one year’s compensation – this is expanded from the existing generally available programs which limit the payments only to the top three senior executives. The guidelines require that institutions receiving any general assistance implement a luxury expenditures policy that is the same as that required of companies receiving exceptional assistance. The existing government programs do not contain a similar requirement.

Compliance

The new restrictions will not apply retroactively to existing investments or to programs that have already been announced, such as the Capital Purchase Program and the Term Asset-Backed Securities Loan Facility. It is important to note that there is no mechanism or procedure currently in place for enforcing any of these restrictions. Rather, the chief executive officers of companies that have received, or do receive, government assistance must provide annual certifications that their institutions have “strictly complied” with statutory, Treasury and contractual restrictions on executive compensation. The compensation committees of these institutions must explain how the compensation arrangements for senior executives do not encourage

unnecessary risk-taking. Again, however, there is no mechanism in place for submitting or filing these certifications or explanations.

Long-term Reforms

Treasury's release noted that "it is not too early to begin a serious effort to both examine how company-wide compensation strategies at financial institutions . . . may have encouraged excessive risk-taking . . . and to begin developing model compensation policies for the future." Along these lines, Treasury suggested the following steps: (1) a joint effort by the Secretary of the Treasury and the Chairman of the Securities and Exchange Commission to require compensation committees of all companies (not limited to those receiving government assistance) to review and disclose executive and certain employee compensation arrangements; (2) implementation of compensation requirements that top executives at financial institutions hold stock in those companies for several years after the award before the stock can be cashed out in order to encourage recipients to take a long-term perspective and focus on creating economic value; and (3) implementation of "say on pay" resolutions, giving shareholders a non-binding voice on the levels and structures of executive compensation.

Conclusion

Treasury will hold a conference on executive compensation, which will seek to establish "best practices and guidelines on executive compensation arrangements." There also are increasing calls for "say on pay" requirements at various companies, both within and outside of the financial industry. In the first quarter of 2008, investors at some 100 companies have asked for a "say on pay."[5]

Thus far, the dialogue on executive compensation at financial institutions has been informed principally by visceral reactions to declining stock prices and continued financial instability. However, there has been (on a relative basis) significantly less discussion regarding the role of boards of directors and compensation committees that have to date been charged with making compensation decisions in an exercise of their business judgment. Moreover, there has been relatively little attention paid to the existing burdens placed on executive officers and directors of reporting issuers, especially in a post-Sarbanes-Oxley world. More and more, executive officers are required to make very difficult decisions, including decisions regarding financial reporting, accounting estimates, accounting policies, valuation of assets, write downs, etc., while they are subject to more scrutiny and more risk as a result of their choices. Given the prospect of shareholder litigation and other litigation and liability concerns, their determinations become fraught with risk. This may inhibit their desire to take risk and may lead them to be more conservative than they otherwise would be. Senior executives at public companies already find that as a result of being public reporting companies, their business choices may be limited—given, in part, earnings pressure and the need to respond to many constituencies (including research analysts, large institutional holders, aggressive hedge fund holders, shareholders, etc.). With Sarbanes-Oxley also came significant limitations on executive compensation arrangements and increased liability for executive officers. It is not clear that the court of public opinion would be the best decision maker in respect of compensation for executive officers.

However, it is clear that Treasury's new guidelines are not the end of the discussion on executive compensation but rather the start of a new era of unprecedented intervention into the decisions of boards of directors on compensation matters.

[5] Barbara Kiviat, *Giving Investors a Say on CEO Pay*, Time Magazine (Apr. 9, 2008) *available at* http://www.time.com/time/printout/0,8816,1729480,00.html#.

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