

Executive Compensation and the Financial Crisis / Bailout

The House Emergency Economic Stabilization Act of 2008 proposed changes in executive compensation and corporate governance. There are three different programs under the Act outlined below that the Treasury Department is working to complete. Each program contains somewhat different executive compensation standards as described below. Rules for each will apply to the CEO, the CFO and the 3 next most highly compensated executive officers.

Troubled Asset Auction Program: This covers any firms that sell more than \$300M of troubled assets to the Treasury via an auction.

- Limits on executive compensation in the form of the loss of tax deductibility under 162(m) for compensation greater than \$500,000.
- A participating company may not deduct certain golden parachute payments to its senior executives.
- A 20% excise tax will be imposed on the senior executive for these golden parachute payments, if made.

Capital Purchase Program: This covers any firms where the Treasury provides equity capital to the financial institutions (i.e., buys stock) to strengthen their balance sheets and facilitate their continued lending in the capital markets.

- Limits on executive compensation in the form of the loss of tax deductibility under 162(m) for compensation greater than \$500,000.
- The incentive compensation (bonuses and long-term incentives) must not encourage unnecessary and excessive risks that threaten the value of the financial institution.
- A prohibition on any golden parachute payments to a senior executive.
- A clawback provision on any bonuses or incentive compensation paid based on information found to be materially inaccurate.

Programs for Systemically Significant Failing Institutions: This is currently under development and will provide direct assistance to certain failing firms on terms negotiated on a case-by-case basis.



DolmatConnell & Partner's Commentary

It should be noted, as no one is openly stating this, that these provisions only apply to executives whose firms participate in the programs under the Emergency Economic Stabilization Act of 2008.

The executive compensation provisions in this Act are weak and poorly thought through at best, are potentially counter-productive, and are damaging at most. Here is why.

Limits on Executive Compensation

Merely attempting to limit executive compensation to \$500,000 by not allowing a tax deduction for amounts that exceed this will do nothing – firms will pay what they want and need to pay, and will forego the tax deduction. Most large firms already forego the tax deduction relative to executive base salaries today. Additionally, most, if not all, of these troubled firms will be in a tax loss situation, so the impact of losing a tax deduction will be inconsequential. Therefore, this provision will certainly not limit or potentially even change executive pay levels.

The Structure of Executive Compensation

Some of the programs focus on executive compensation that has the potential to promote taking unnecessary and excessive risks that threaten the value of the financial institution, which sounds on the surface like an appropriate thing to do. Presumably, this includes all incentive compensation, which raises two significant issues. First, who determines what compensation plans, and what metrics in those plans, would create unnecessary and excessive risk? Second, by potentially prohibiting appropriate incentive compensation (bonuses, stock options, etc.), what incentive is there for executives to improve the financial performance of the organization and meet or exceed business goals? Perversely, by allowing existing executives to maintain their severance agreements in most instances, as long as they are not above the 2.99 times base earnings limit (discussed below), and by excluding deductions on incentive pay above \$500,000, the true incentive for executives may be to allow the organization to fail. We believe that the real issues with inappropriate incentive compensation amounts and structures are actually found in the plans below the top executive levels within these troubled companies.



Severance and Golden Parachutes

The current guidelines only prohibit that no severance or change-in-control payments can be made to executives of systemically significant failing institutions. This could be an issue since those very companies are most likely in need of recruiting new executives to attempt to turn their firms around. By not allowing them to have severance or change-in-control payouts, or by severely limiting the payouts, those companies will face massive challenges in recruiting new executives in these troubled times.

Under the Troubled Asset Auction Program, merely changing the deductibility for companies and imposing the 20% excise tax on executives will not curb these payments. Many are non-deductible as structured today, and many companies also gross executives up for the 20% excise tax, so this will likely have minimal impact on companies' decision-making processes. Under the Capital Purchase Program, the prohibition is on making any parachute payment under Section 280(g) of the Internal Revenue Code, which governs parachute payments. This section of the Code only becomes effective if the payments are greater than 2.99 times an executive's average 5-year W-2 earnings. In most cases, this average amount for an executive is quite significant. Assume a CEO has an average 5-year W-2 earnings level of \$10M per year, which is possible because those amounts include not only base salary and bonus payments but also restricted share vesting and option exercise. Thus, as long as the severance or change-in-control payments are less than \$30M, it is not be governed by the tax code and therefore not covered under this Act.

Clawbacks

This provision of the plan makes total sense, and is in fact already in place at many organizations today. This would allow a company to re-capture incentive payments that were made based on misleading financial information.

What Should Be Done?

There are several solutions that could easily be implemented that would be infinitely better than those currently proposed in this bill.

1. Executives should be paid, and companies allowed to deduct, a market competitive rate of pay for the work they do – this is the only way to get and keep executives with the talent to turn these organizations around. Companies should work with new, and truly independent executive compensation consultants with no history with these firms to determine a



reasonable rate of pay for the size and scope of the firm being bailed out and let the determined amount be a cap on executive pay, and not what the firm can deduct.

2. Demand that incentive compensation is focused on the recovery of the firm and its return to the taxpayers. Cap upside potential of any incentive plans with “collars.”
3. For firms to participate in the program, they must agree to restructure the severance and change-in-control arrangements for existing executives to reasonable levels. Place a cap on the amount of allowable severance and/or change-in-control payments that would be made.
4. Allow new executives in the systemically significant failing institutions to have severance and change-in-control arrangements up to the allowable cap and modified by length of service to avoid the situation that occurred at Washington Mutual.

Implications for the Broader Executive Compensation Market

While very few of the public companies in this country are impacted by the bill, all public companies in the U.S. need to pay close attention to the intense media scrutiny and public outrage over executive compensation at the “failed” financial firms. Perception equals reality, and the perception in this country - by the media, investors, the public and the legislature - is that executive compensation is out of control and not linked to performance, particularly negative performance. Proactive change is necessary to avoid broader regulations and legislation. Companies should consider:

- Limiting executive severance and change-in-control agreements to a multiple of 1.0 – 1.5 times annual base salary and target bonus, the length of time it should at maximum take a CEO or executive officer to find a new role, which was their original intent. They only increased to 2.0 – 3.0 times base and bonus when Section 280(g) was adopted.
- There should be no severance or change-in-control payments if the company is involved in a government bailout, a bankruptcy filing, or if the stock price drops by more than a given percentage in the year preceding the departure, say 80%.
- Implement aggressive share ownership requirements for executives and Board members. Real ownership drives better performance.



Was Executive Compensation to Blame for the Financial Sector Meltdown?

Much has been talked about in recent weeks with respect to executive compensation's role in the financial sector meltdown – how it promoted too much risk-taking which led to exceptional short-term gains at the expense of the long-term company stability. We have analyzed the pay structures of the firms that have failed, needed a bailout or have been taken over (AIG, Bear Stearns, FannieMae, FreddieMac, Lehman and Morgan Stanley) vs. those that have remained relatively strong in these troubled times (Bank of America, Goldman Sachs, and JP Morgan), and also how CEO compensation in these companies compares to that of non-financial services firms in the NYSE100, as well as the broader NYSE100, and found some surprising results.

The financial services firms have significantly greater portion of their compensation in the form of short-term bonuses than the NYSE100 non-financial firms. The financial services firms have 3.3% of compensation in the form of base salaries and 24.4% in short-term incentives (a 7.4 to 1 ratio) whereas the non-financial firms have 8.3% in base salary and 20.1% in short-term incentives (a 2.4 to 1 ratio). This clearly indicates a much higher priority on short-term objectives, which could create a higher penchant for short-term risk.

This short-term and perhaps more risk-oriented package is, however, more than offset by several other components of pay:

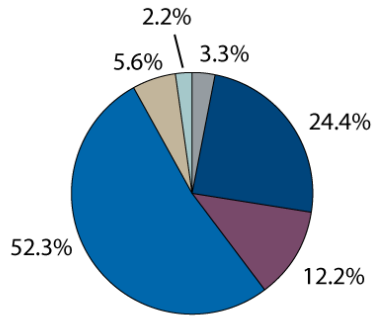
- Stock options, which are considered the most “risk-oriented” form of long-term compensation as there is “no skin in the game”, comprise 12.2% of the total compensation package at the financial services firms whereas they are 23.8% of the total in non-financial firms.
- Time-based restricted shares, which are the most risk-free form of long-term compensation (they are often termed “pay for showing up”,) represent 52.3% of the total pay package in the financial services firms vs. 9.9% in non-financial services firms. This created significant real ownership in these firms, much of which evaporated during the meltdown (e.g., James Cayne, the former CEO of Bear Stearns, saw the value of his real stock ownership fall from \$1.06B to \$61.2M and Richard Fuld, the CEO of Lehman Brothers, saw the value of his real stock holdings decline from \$827M to \$2.3M.) This is counter to most “high-risk” models which have little real ownership and highly leverage stock option based packages.

- There is a surprising lack of prevalence of performance-based long-term incentive plans in the financial services firms. Only two of these firms have used performance-based LTIPs at least once over the last three fiscal years, vs. the 81.3% of non-financial NYSE100 firms who have used performance-based LTIPs at least once over the last three years. As performance-based LTIPs most commonly employ multi-year performance measures, this could indicate a penchant for a shorter-term focus.

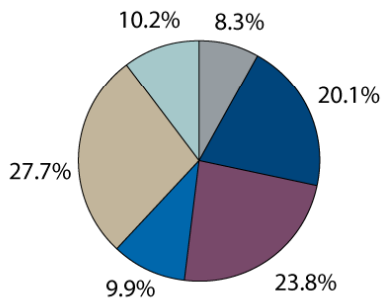
CEO compensation is easy to place in the cross-hairs. However, this does not seem to be the problem on Wall Street and in the financial sector. The problem is the compensation of the traders, Managing Directors, other specialists in these firms. CEO and Top 5 executive compensation are publicly disclosed, and while high, are not astronomical for firms of this size. What is astounding are the \$25M, \$50M and \$100M packages of individuals farther down in these companies. They are paid astronomical sums based on the short-term transactions they sell – like a commissioned salesperson. These compensation packages are of the types that cause inordinate risk-taking, especially when the strategies and instruments they use/sell are beyond the intellectual capability of 99.99% of the population, which includes the CEOs and Boards of these companies. This was a governance problem, not an executive compensation problem.



Financial Services Firms



NYSE 100 excluding Financial Services



NYSE 100

