

TARP and the Transformation of Executive Compensation

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The current economic crisis has triggered heightened public and governmental scrutiny of financial institutions with a view toward exposing and regulating the practices and behaviors that triggered the near collapse of the world banking system. For businesses that are receiving U.S. government funding, executive compensation is subject to particular public scrutiny and growing legal regulation. However, the current climate has caused most American businesses to rethink executive compensation and its effectiveness in achieving organizational goals.

EXECUTIVE COMPENSATION UNDER TARP

Corporate recipients of federal funds under the Troubled Asset Relief Program ("TARP") are subject to stringent laws affecting executive compensation. For example, no golden parachute may be paid to the top 5 most highly compensated unless the payment is for services already performed or benefits accrued. Bonuses, retention awards, incentive compensation (other than restricted stock meeting certain requirements) are prohibited for covered executives. TARP recipients are required to establish limits on compensation to discourage inappropriate risk taking, and to claw back any bonus, retention or incentive award to the top-paid

25 if financial statements are materially inaccurate. In addition, each TARP recipient is required to establish a compensation committee of independent directors, establish company-wide policies limiting excessive perquisites, and solicit non-binding "say-on-pay" shareholder votes to approve executive compensation. The tax deduction on the deductibility of executive pay under Code §162(m) is also limited to \$500,000 for TARP recipients (as compared to \$1 million for non-TARP, public companies) with no exception for performance-based compensation.

These rules became law under the Emergency Economic Stabilization Act of 2008 ("EESA") and are widely viewed as an impetus for more changes in executive compensation of public companies.

CHANGES IN PRACTICE

In the context of collapsing equity values, many features of executive compensation are now being redesigned as a matter of practice. Equity compensation, tax gross-ups and severance packages for terminated executives in public companies are now particularly subject to cutbacks and restructuring. Providing executives with extra cash to pay excise taxes on golden parachutes, once a negotiable point, for example, is now a non-starter. Double triggers (that is, requirements of both a change in control of the public corporation plus the loss of the executive's job) are now becoming standard pre-conditions for executive exit packages in public companies. Stock options, once a staple of executive compensation, are now on the wane, in part because they subject executives to too little downside risk and are thought to encourage too much inappropriate risk-taking by management to the detriment

of the corporation. Instead, equity compensation is being redesigned to give executives a greater stake in both the long-term fortunes and misfortunes of the corporation, and to reduce the amount of risk that short-term equity compensation encourages executives to take. As a result, performance-based, restricted shares are increasingly replacing stock options. In addition, under many new equity programs, vesting is triggered only if the company has both increased value for its shareholders and performed well against its peers.

Perquisites, such as country club memberships, company cars and use of a private aircraft are subject to curtailment as well.

Similarly, long-term income and retirement programs for executives of public corporations are being re-examined. Under particular scrutiny are defined benefit retirement pay packages to executives and death benefits to their families. These benefits are expensive to fund and subject the corporation to market risk. They also attract criticism, particularly if other employees' retirement benefits are subject to market risks.

Also under scrutiny is the process by which public companies determine executive compensation. It has been common, for example, for boards of directors of public companies to be populated by former CEOs, and other insiders who have been lenient in setting and increasing executive compensation. Congress, institutional shareholders and public watchdog organizations have recently been reviewing these practices with a view toward instituting structural changes that add greater independence to the bodies overseeing

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executive compensation. By replacing ex-CEOs and other insiders with independent directors, and by requiring outside executive compensation consultants on compensation committees, it is expected that a greater balance of interests will inform the process of setting executive compensation.

POSSIBLE LAW CHANGES

At this writing, bills are now percolating in Congress which are directed at regulating executive compensation of all public companies. For example, one bill would require non-binding shareholder approval of executive compensation packages (“say-on-pay”). Other proposals of executive compensation in public companies are aimed at further limiting the deductibility of executive compensation; requiring clawbacks of compensation for misstatements in financial reporting and other executive malfeasance; requiring an independent outsider as chairman of the board of directors; requiring the annual election of directors; instituting risk committees on boards to monitor the behavior of management, and prescribing by law the permitted ratio of executive pay to the median pay of workers.

The current economic crisis has already proven itself a watershed event. It is sure to be the triggering event of a host of new regulations including changes designed to curb real and perceived abuses affecting many executive compensation programs.

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