

THE NATIONAL LAW JOURNAL

DAILY UPDATES ON WWW.NLJ.COM

NEWS FOR THE PROFESSION

MONDAY, NOVEMBER 17, 2008

An *incisivemedia* publication

IN FOCUS

CORPORATE GOVERNANCE

Eyeing executive compensation

Pay structures often spur chiefs to focus on short-term results rather than long-term value.

By Christopher Keller and Michael Stocker
SPECIAL TO THE NATIONAL LAW JOURNAL

AT THE HEART OF THE financial crisis that has paralyzed global financial markets is a mystery: How could the masters of the world's most sophisticated banks and financial institutions stake the lives of their businesses on collateralized debt obligations and mortgage-backed securities that have proved to be so toxic? The answer may lie in the murky world of executive compensation, and efforts to prevent similar catastrophes in the future could depend on unlocking its secrets.

In retrospect, it is easy to understand the short-term allure of securities backed by subprime and alt-A mortgages. The rapid rise in housing prices between the years 2000 and 2005 meant that even high-risk borrowers could be expected to profit on the resale of their homes, reducing the danger of losses through foreclosure.

However, banks and financial institutions understood that there were great dangers in securities backed by such loans as well. Given the historic cyclical nature of the housing market, the window in which such loans might be profitable was likely to be limited. Moreover, as more higher-risk loans were written, the quality of borrowers steadily declined and the chance of default rose dramatically.

In spite of these risks, investment banks such as Lehman Brothers Holdings Inc. and insurers

Christopher Keller, a partner at New York-based Labaton Sucharow, concentrates his practice in sophisticated securities class litigation in federal courts throughout the country. He has served as lead counsel in more than a dozen options backdating class actions. Michael Stocker, an associate at the firm, represents clients in commercial litigation, with a primary focus on antitrust and securities class action matters.

like American International Group Inc. (AIG) bet that the real estate market would never cool. Analysts and taxpayers alike have been shocked that pillars of the financial community risked so much, and with such devastating consequences.

The victims of the carnage in the market for mortgage-backed securities are already familiar. Fannie Mae and Freddie Mac, companies that account for half of the nation's mortgage debt, were rescued only after a \$200 billion injection of capital supplied by U.S. taxpayers. Bear Stearns Cos., once the nation's fifth-largest investment bank, was ignominiously bought by JPMorgan

Governance-based compensation reform is gaining traction.

Chase & Co., using a government-subsidized loan. Lehman Brothers, once the fourth-largest investment bank, was left to expire on its own, while taxpayers funded a \$123 billion loan to keep struggling insurance behemoth AIG afloat. Washington Mutual Inc. tanked in the largest bankruptcy in U.S. history.

With the benefit of hindsight, the catastrophes that befell these companies should have been no surprise. The philosophy that underpinned the irrational risk undertaken by companies like Lehman Brothers and Bear Stearns has long been the subject of criticism.

Early warnings of the crisis

Years before the current crisis erupted, analysts suggested that the new generation of executives of publicly held companies were gambling long-term

economic stability in order to achieve short-term financial goals. In a 2007 statement by the Research and Development Committee of the Committee for Economic Development (CED), a distinguished panel of business, academic and policy leaders, lamented the focus of corporate executives on short-term financial results rather than long-term value and stability. The panel suggested that "[d]ecision making based primarily on short-term considerations damages the ability of public companies, and therefore, of the U.S. economy to sustain superior long-term performance." "Built to Last: Focusing Corporations on Long-Term Performance," Committee for Economic Development, 2007, at 1, www.ced.org/docs/report/report_corpgov2007.pdf.

The CED panel suggested that this preoccupation with short-term results at the cost of long-term success was in large part due to the nature of the compensation packages being offered to management, particularly excessive payments to corporate executives to meet short-term and "low-aspirational" targets. *Id.* at 2. The perils associated with these short-term performance goals, the panel explained, are only compounded by reliance on recruited executives who serve only short terms. When retirement is only one or two years away, there is little incentive to assess the long-term dangers posed by investments. *Id.* at 16.

The CED's conclusions echoed a 2003 National Association of Corporate Directors (NACD) study, Blue Ribbon Commission Report on Executive Compensation and the Role of the Compensation Committee, www.directorsforum.com/resources/related_articles/NACD_BRC_Report.pdf. The NACD recommended that publicly held companies use both qualitative and quantitative measures in compensating executives for performance, and decrease reliance on stock price as a performance measure.

By early this year there was ample evidence of

the growing disconnect between performance-based compensation and actual value added to publicly held companies in the United States. In 2007, when the effects of the mortgage crisis were already well advanced, Wall Street bonuses totaled \$33.2 billion—down by just 2% from highs in the flush year of 2006. Indeed, 2007 bonuses for seven of Wall Street's top firms were up by 10% from 2006, despite \$200 billion in lost shareholder value during the preceding year. Tomoeh Murakami Tse and Renae Merle, "The Bonuses Keep Coming," *Wash. Post*, Jan. 29, 2008, at D1.

The collapse of Bear Stearns provides a painful illustration of the downside to rewarding short-term success. In 2006, at the height of the real estate bubble, former Bear Stearns Chief Executive Officer James Cayne took home more than \$40 million, including a \$17 million bonus, nearly \$15 million in restricted stock awards and \$1.6 million in stock options.

In a March 27, 2007, proxy statement, Bear Stearns explained that "[t]he Company's performance as measured by profit margins remained strong and earnings per share increased over the prior year. In addition, return on common equity was among the highest of the Company's key competitors. The compensation paid to the Company's executive officers for fiscal 2006 reflects the strength of this performance."

Less than a year after the proxy statement was issued, Bear Stearns announced that, as a result of the collapse of the market for securities backed by subprime mortgages, it was being sold to JPMorgan for \$2 per share.

The juxtaposition of the enormous performance-based bonuses granted by Bear Stearns in 2007 and the company's collapse just months later resulted from compensation awards that were largely disconnected from any long-term measure of value added to the company.

Mixed results from regulation

Regulatory efforts to rationalize performance-based executive compensation have thus far seen mixed results. At the end of 2006, in an effort to provide investors with a better understanding of the relationship between compensation-related performance goals for executives and the long-term interests of publicly held companies, the U.S. Securities and Exchange Commission (SEC) issued new and revised rules relating to executive compensation disclosure. In amendments to Item 402 of Regulation S-K relating to executive compensation, the SEC required that companies provide "clear, concise, and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers...and directors...by any person for all services, rendered in all capacities." 17 C.F.R. 229.402(a)(2).

These new rules apply to chief executive officers or individuals serving in a similar capacity; the registrant's four most highly compensated executive officers other than the CEO who were serving as executive officers at the end of the last completed fiscal year; and up to two additional

individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year. 17 C.F.R. 229.402(a)(3).

In the months following the imposition of the regulations, however, the SEC showed little appetite for their enforcement. Although in 2007 the SEC issued comment letters to companies it perceived as failing to comply with these disclosure requirements, the commission indicated that the letters were intended only to provide guidance for future filings.

Not surprisingly, companies have been slow to comply. A 2007 review of compliance with the new rules revealed that, although 62% of companies disclosed long-term compensation-related performance goals, only 47% of companies required to make disclosures revealed the nature of short-term performance goals for their top management. Gretchen Morgenson, "If the Pay Fix is In, Good Luck Finding It," *N.Y. Times*, Sept. 7, 2008, at BU1.

Provisions in bailout legislation

The recent controversy over the federal bailout of the U.S. capital markets has renewed interest in strengthened regulatory controls over executive compensation. The Emergency Economic Stabilization Act of 2008, passed on Oct. 3, contains provisions significantly restricting executive compensation for financial institutions in which the federal government takes a significant debt or equity stake.

For these institutions, the act forbids incentives for taking unnecessary and excessive risks that threaten the value of the financial institutions. Other provisions provide for the clawback of bonuses and other incentive compensation based on materially inaccurate financial data and prohibit "golden parachute" payments for departing senior management.

The most drastic executive compensation measure contained in the act amends § 162(m) of the Internal Revenue Code with respect to companies that accept bailout funds. This rule traditionally puts a \$1 million limit on the compensation a company can deduct for its top-paid officers, but did not apply to performance-based compensation. As a result, there can be a strong tax incentive for companies to shift as much executive compensation as possible into the performance-based bonuses that have been the subject of so much abuse.

The amendments to the rule require that, for covered financial institutions, compensation must include all payouts for services, including compensation that otherwise would be exempted because it is "performance-based" within the meaning of § 162(m)(4)(C). By amending the rule to cover performance-based compensation as well, Congress at least theoretically makes such arrangements considerably less attractive for the financial institutions accepting bailout dollars.

Commentators suggest that these provisions ultimately may do little to address the problems of executive compensation. Many of the new rules

apply only to companies that take advantage of the new bailout provisions. Moreover, companies could easily evade rules forbidding "golden parachutes" by simply building retirement awards into the salary granted executives during the term of the contract.

Ultimately, the cheapest and most effective route to reform executive compensation may be through changes in corporate governance. Under current rules, company executives largely control the composition of the boards of directors of public companies. Company management typically nominates the slate of directors for election, and only management choices for board positions are included in the proxies they send to shareholders. As a result, the board members who should act as watchdogs for the interests of shareholders tend to be beholden to company executives, and offer little resistance to extravagant executive compensation packages.

Efforts to control executive compensation through corporate governance initiatives focus on increasing director independence by letting shareholders nominate directors to compete with those selected by company management. Still other measures, referred to as "say on pay," would require that shareholders be permitted to offer at least an advisory opinion on the propriety of compensation packages offered to company management. While these opinions would not be binding, compensation committees could ignore them at their peril.

There is some evidence that governance-based compensation reform is gaining traction. According to a recently-released report, say-on-pay proposals have been presented in the 2008 proxy season at 41 of the top 100 U.S. publicly held companies. Shearman & Sterling, "2008 Trends in Corporate Governance of the Largest U.S. Companies: Director and Executive Compensation" (2008); see press release, at www.shearman.com/corpgovpr/.

It remains to be seen whether these shareholder-driven efforts will meet with any greater success than the largely ineffectual regulatory attempts to solve the problems posed by the short-term focus of many executive compensation packages. As frustration grows with the pace and scale of the reform of the U.S. financial industry, these measures are likely to be the subject of increasing attention. **NM**

Reprinted with permission from the November 17, 2008 edition of the NATIONAL LAW JOURNAL © 2008 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints.customerservice@incisivemedia.com. ALM is now Incisive Media, www.incisivemedia.com. # 005-11-08-0011

**Labaton
Sucharow**