

Meridian Client Update

July 27, 2010

Pay Czar Rules on Large Bank's Prior Pay Practices

On July 23, 2010, Kenneth Feinberg, the Special Master under TARP, issued a report which found executive compensation practices in late 2008 and early 2009 at TARP recipient banks **were not contrary to the "public interest."** Mr. Feinberg evaluated compensation paid by TARP recipient banks to their Top 25 executives prior to February 17, 2009. On that date, President Obama signed into law the American Recovery and Reinvestment Act ("Recovery Act") which subjects TARP recipient banks to certain executive compensation and corporate governance standards and mandates that the Special Master evaluate bank pay practices prior to that date.

In all, Mr. Feinberg's pay review covered 419 banks that received TARP funds prior to February 17, 2009. The review primarily focused on compensation paid to a bank's Top 25 employees who earned more than \$500,000 per year. The review then narrowed its focus to compensation paid that, although legal at the time, was later restricted or prohibited under the Recovery Act and applicable Treasury regulations (e.g., prohibition on certain bonuses, incentive arrangements and severance payments and limitations on stock payments). If the Special Master found that any compensation paid was "contrary to the public interest," the Recovery Act directs the Special Master to seek to negotiate the return of such compensation to the federal government. **However, the Special Master has no specific statutory authority to force the return of compensation from affected banks or employees, or require any other remedy.**

Mr. Feinberg's report found the following:

- 240 banks had **no employees** who received pay in excess of \$500,000 per year.
- 116 banks had **five or fewer employees** who received pay in excess of \$500,000 per year.
- Of the \$2.3 billion of compensation reviewed, \$1.7 billion of compensation would have later been prohibited under the Recovery Act.
- 17 banks paid \$1.6 billion of the foregoing \$1.7 billion of compensation to their top paid employees (the 17 banks were not indentified in the report but presumably are among the 25 largest U.S. banks).

On the basis of these findings, Mr. Feinberg concluded that no compensation payments were "contrary to the public interest." Mr. Feinberg's conclusion was apparently impacted by the report's finding that all subject compensation payments were permitted and lawful at the time made and that 11 of the 17 banks (referenced above) have fully repaid their TARP funds to the federal government.

Although not required under the Recovery Act, Mr. Feinberg submitted a non-binding proposal directly to the 17 banks calling for these banks to provide their compensation committees with special rights to restructure compensation in the event of a "crisis situation." Under the proposal, if a bank's board of directors has determined that the bank is in a crisis situation, the compensation committee would have the authority to restructure, reduce or cancel pending payments to executives – and this authority would supersede any rights and entitlements executives may have to such payments in the normal course. The report notes that the proposed policy would give compensation committees flexibility and authority to set and adjust appropriate

compensation at crucial moments, consistent with provisions of the new Dodd-Frank Wall Street Reform and Consumer Protection Act, which strengthens compensation committee independence. The report further notes that the proposal is consistent with banking regulators' principles for sound incentive compensation practices, which call for effective oversight by directors and an appropriate balance of risk and reward.

Mr. Feinberg will be issuing a set of principles to guide banks that adopt his voluntary proposal.

Mr. Feinberg's conclusions are not surprising, but are likely welcomed by the banking community. Lacking legal authority to recover any compensation payments on behalf of taxpayers, Mr. Feinberg may have reasoned that seeking recovery directly from executives would have been an exercise in futility. Further complicating any recovery efforts is the fact that the reviewed compensation payments were lawful and permitted at the time made, as was repeatedly noted in the report.

With regard to Mr. Feinberg's proposal to the 17 banks, it is unclear if any of these banks will fully adopt the proposal. Broadly, compensation committees at large banks already have some of the authority contemplated in Mr. Feinberg's proposal. Typically, compensation committees have the authority and sole discretion to reduce incentive awards payable to top executives and, in certain circumstances, claw back awards which have already been paid (the Dodd-Frank Act now mandates the recovery of erroneously paid incentive awards). In addition, compensation committees generally have limited authority to restructure ongoing pay programs in the event of extraordinary circumstances. However, Mr. Feinberg's proposal suggests compensation committees should be provided much broader authority, perhaps even including the authority to cancel or restructure outstanding stock option and restricted stock awards and compensation payments not otherwise subject to compensation committee discretion.

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