

## Outside Counsel

## Expert Analysis

# The Treasury Department's 'Compensation Czar'

America is in the midst of a regulatory “czar” craze. According to a recent news report, President Barack Obama has “nearly three dozen czars in his administration, managing everything from closing the Guantánamo Bay detention facility to ending the genocide in Darfur.”<sup>1</sup> The word “czar” has Russian origins, and is defined as “a person with great power in a particular area.”<sup>2</sup>

Of the newly appointed American “czars,” the one with perhaps the highest profile is the “compensation czar,” attorney Kenneth R. Feinberg, who is best known for serving as the Special Master of the Federal September 11th Victim Compensation Fund of 2001. In June 2009, under the authority of an Interim Final Rule (IFR) called Troubled Asset Relief Program (TARP) Standards for Compensation and Corporate Governance,<sup>3</sup> U.S. Secretary of the Treasury Timothy Geithner appointed Mr. Feinberg as the Special Master for TARP Executive Compensation.

Although Mr. Feinberg has rejected the moniker “compensation czar,” with its negative connotation that he will be imposing compensation standards by decree,<sup>4</sup> his special master position is nonetheless one vested with vast powers, both those explicitly set forth in the IFR, and those that exist by way of implication (few CEOs will dare resisting the “suggestions” of the “compensation czar” on pain of getting shamed publicly as an out-of-touch, greedy executive).

One of the motivations for the statutory authority allowing the implementation of the IFR is that the current recession was caused,

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at least in part, by risky behavior by corporate executives who were looking to score short term gains that would justify outsized bonuses and compensation packages. Mr. Feinberg was appointed to regulate, for those firms that have received federal funds under TARP, what is widely viewed as a compensation system in corporate America that has lost its bearings.<sup>5</sup> His appointment was also likely motivated by the furor that has boiled over due to the disconnect between large bonuses paid to executives and massive corporate losses, as well as the fact that some of the largest Wall Street firms collectively paid out \$26.895 billion in bonuses for 2008, despite collectively losing \$44.4 billion.<sup>6</sup>

Although all TARP recipients are subject to the IFR, it contains additional requirements for those firms that received “exceptional financial assistance” under TARP and other government programs, which include Citigroup Inc. (\$25 billion), Bank of America Corp. (\$15 billion), American International Group Inc. (\$80 billion), Chrysler Group (\$15 billion), General Motors Corp. (\$50.7 billion), Chrysler Financial (\$1.5 billion) and GMAC (\$12.5 billion).<sup>7</sup>

The government acquired the right to regulate executive compensation as a consequence of the financial crisis that gripped the country starting in the fall of 2008. In October 2008, the Treasury Department established the Troubled Asset Relief Program (TARP) under the Emergency

Economic Stabilization Act of 2008 (EESA), as amended.<sup>8</sup> Under the American Recovery and Reinvestment Act of 2009 (ARRA), which amended Section 111 of the EESA, companies that receive financial assistance under TARP are subject to executive compensation and corporate governance standards established by the Secretary of the Treasury. The IFR implements those standards, which apply to firms so long as they have an obligation to the government based on financial assistance provided under TARP.<sup>9</sup>

As stated in the IFR, its overarching principles are to regulate executive compensation in order to (1) maximize overall returns to the taxpayers of the United States and (2) provide stability and prevent disruptions to the financial markets.<sup>10</sup> The IFR sets forth the following general goals and standards:

(1) Limits on compensation that exclude incentives for senior executive officers (SEOs)<sup>11</sup> to take unnecessary and excessive risks that threaten the value of the TARP recipient; (2) provision for the recovery of any bonus, retention award, or incentive compensation paid to an SEO or the next twenty most highly compensated employees based on materially inaccurate statements of earnings, revenues, gains, or other criteria; (3) prohibition on making any golden parachute payment to an SEO or any of the next five most highly compensated employees; (4) prohibition on the payment or accrual of bonus, retention award, or incentive compensation to SEOs or certain highly compensated employees, subject to certain exceptions for payments made in the form of restricted stock; (5) prohibition on employee compensation plans that would encourage manipulation of earnings reported by the TARP recipient to enhance an employee’s compensation; (6) establishment of a compensation committee of independent directors to meet semi-annually to review employee compensation plans and

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the risks posed by these plans to the TARP recipient; (7) adoption of an excessive or luxury expenditures policy; (8) disclosure of perquisites offered to CEOs and certain highly compensated employees; (9) disclosure related to compensation consultant engagement; (10) prohibition on tax gross-ups to CEOs and certain highly compensated employees; (11) compliance with Federal securities rules and regulations regarding the submission of a non-binding resolution on CEO compensation to shareholders; and (12) establishment of the Office of the Special Master for TARP Executive Compensation (Special Master) to address the application of these rules to TARP recipients and their employees. Among the duties and responsibilities of the Special Master with respect to TARP recipients of exceptional assistance is to review and approve compensation payments and compensation structures applicable to the CEOs and certain highly compensated employees, and to review and approve compensation structures applicable to certain additional highly compensated employees. TARP recipients that are not receiving exceptional assistance may apply to the Special Master for an advisory opinion with respect to compensation payments and structures.

### Factors

As guideposts for implementing compensation schemes to meet these goals, the IFR provides that the special master should take into account the following factors:

- **Risk.** The compensation structure must avoid incentives that reward employees for short-term or temporary increases in value or performance. Incentive payments should be structured to be paid over time so that the payments reflect whether the employee's performance actually contributed to the long-term value of the company.<sup>12</sup>
- **Taxpayer Return.** The compensation structure must allow the firm to remain competitive, recruit and retain employees, all with the goal of allowing it to repay the TARP money.<sup>13</sup>
- **Appropriate Allocation.** The IFR encourages allocating a significant portion of overall compensation as long-term compensation that aligns the employee's interest with those of the firm's shareholders and the taxpayers.<sup>14</sup>
- **Performance-Based Compensation.** An "appropriate" portion of compensation should be "performance-based over a relevant performance period." The regulations provide

that such compensation should be determined "through tailored metrics that encompass individual performance and/or the performance of the TARP recipient or a relevant business unit taking into consideration specific business objectives."<sup>15</sup>

- **Comparable Structures and Payments.** The compensation structures and amounts payable at any given firm should be similar to and not "excessive" as compared to those at other similarly situated firms.<sup>16</sup>

- **Employee Contribution to TARP Recipient Value.** The compensation scheme should take into account the current or prospective contributions of an employee to the firm's value, taking into account revenue production, expertise, compliance with company policy and regulation (including risk management), and corporate management, as well as any role the employee might have regarding change in the firm's health or competitive position.<sup>17</sup>

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The position of Kenneth R. Feinberg, special master for TARP Executive Compensation, is one vested with vast powers.

The operative provisions of the IFR are contained in its 17 "question and answer" sections, which cover 19 pages of the Federal Register. They include:

- TARP recipients "must prohibit the payment or accrual of any bonus payment during the TARP period" to certain CEOs and highly compensated employees, the number of which depends on the monetary amount of TARP assistance.<sup>18</sup> This rule does not apply to bonus payments required to be paid under a valid employment contract if an employee had a legally binding right to the payment as of Feb. 11, 2009.<sup>19</sup>
- A limitation on the awarding of long-term restricted stock to CEOs and highly compensated employees, such that any such award cannot exceed one-third of the employee's annual compensation.<sup>20</sup>
- TARP recipients must "prohibit any golden parachute payment to an CEO and any of the next five most highly compensated employees during the TARP period" and also create an excessive or luxury expenditures

policy (including posting this policy on its Web site).<sup>21</sup>

- TARP recipients must establish a compensation committee that among other things must "discuss, evaluate and review" compensation plans to ensure that they do not encourage CEOs to take unnecessary and excessive risk that threaten the value of the company.<sup>22</sup> The compensation committee must also identify features in the company's compensation plan that expose or otherwise encourage behavior focused on short-term results and not long-term value creation and ensure that the plans limit such behavior. There is also a certification requirement that these actions have taken place, as well as all other actions and obligations under the IFR.<sup>23</sup>

- TARP recipients must establish a mechanism to "clawback" any bonus payments if the bonus payment was based on materially inaccurate financial statements or any other materially inaccurate performance metrics.<sup>24</sup>

### Responsibilities

The special master is vested with the responsibility for interpreting Section 111 of the EESA and the IFR and how they apply to any set of facts and circumstances.<sup>25</sup> Among other things, the special master is charged with determining if any TARP recipient paid compensation to any employee before Feb. 17, 2009 to determine if such payments are inconsistent with the EESA or TARP or otherwise contrary to the public interest, and to negotiate with both the TARP recipient and the employee the repayment of the compensation in question.<sup>26</sup>

For firms receiving "exceptional financial assistance," the special master shall determine for each CEO or most highly compensated employee whether the compensation structure for each such individual meets the requirements set forth in the IFR.<sup>27</sup> Initial submissions were submitted on Aug. 14, 2009, and the special master has 60 days to review and approve those submissions. The special master must also determine for any employee who is an executive officer or one of the 100 most highly compensated employees of a TARP recipient receiving exceptional assistance who is not prohibited from receiving a bonus under the IFR, whether that employee's compensation meets the IFR's requirements.<sup>28</sup> The special master may also provide advisory

opinions for other TARP recipients regarding payments or compensation schemes.<sup>29</sup>

The Treasury Department's IFR on compensation suggests that a powerful bureaucrat can calibrate compensation plans across a broad array of dissimilar industries, in a way that will safeguard the economy from corporate executives who the government does not trust to put aside their self-interest in maximizing their earnings in favor of the stability of the financial markets. Mr. Feinberg's emphatic rejection of the "czar" title is telling, however, and suggests his unease with the vast power that has been placed in his hands and the ability of a special master to impose the goals contemplated by the IFR.

Indeed, in spite of the road map that the IFR sets out for building a perfect pay plan, Supreme Court Justice Potter Stewart's famous concurring opinion in *Jacobellis v. Ohio*,<sup>30</sup> where he concluded that he would "know" hard-core pornography when he "sees it," suggests that in practice a special master, too, will know an excessive pay plan when he sees one.

Although the government surely has a right to try and ensure that taxpayer bailout funds do not get squandered on rich and undeserving pay packages, and while Mr. Feinberg is an expert mediator who will bring to bear his skills in crafting compensation schemes that comport with the IFR, it is nonetheless an open question whether he can balance the needs of the companies in question that must pay competitively in order to attract and retain top talent, against the heat from politicians calling for the heads of overpaid executives.

Even a "czar" might not have the power to stop Congress from legislating unwisely, such as when the House of Representatives passed earlier this year a legally dubious, confiscatory 90 percent retroactive tax on bonuses paid to executives at AIG.<sup>31</sup> The country's lack of success in having "czars" serve as cure-alls for intractable problems (e.g., "drug czar") suggests that no matter the good will and judgment of the "compensation czar," the solution to the problem of excessive executive pay requires both regulation and the leadership of corporate leaders who can help the market correct itself.



1. "Some Question Whether Obama Has Too Many 'Czars,'" July 14, 2009, <http://www.foxnews.com/politics/2009/07/14/question-obama-czars/>.

2. Concise Oxford English Dictionary (11th Ed. Oxford Univ. Press 2004).

3. 31 CFR Part 30. 28394 Federal Register/Vol. 74, No. 113/ Monday, June 15, 2009/Rules and Regulations.

4. "I recoil when I hear or read in the press that I'm some type of compensation czar, like I'm going to issue imperial edicts against company officials. I think that's a very poor choice of a noun describing my role. ...I would rather like to think of myself as an individual who will work with these companies in a win-win situation, developing compensation structures and amounts consistent with the public interest. And that's going to be the challenge...." Don't Call Kenneth Feinberg a Compensation 'Czar,' [http://www.npr.org/blogs/thetwo-way/2009/06/dont\\_call\\_compensation\\_czar\\_a.html](http://www.npr.org/blogs/thetwo-way/2009/06/dont_call_compensation_czar_a.html)

5. Pay Czar Is Expected to Clear AIG Chief's Compensation, Aug. 28, 2009, [http://online.wsj.com/article/SB125132944648562141.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB125132944648562141.html?mod=googlenews_wsj).

6. "No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture," Andrew M. Cuomo, Attorney General, State of New York, July 30, 2009 ("An analysis of the 2008 bonuses and earnings at the original nine TARP recipients illustrates the point. Two firms, Citigroup and Merrill Lynch suffered massive losses of more than \$27 billion at each firm. Nevertheless, Citigroup paid out \$5.33 billion in bonuses and Merrill paid \$3.6 billion in bonuses. Together, they lost \$54 billion, paid out nearly \$9 billion in bonuses and then received TARP bailouts totaling \$55 billion. For three other firms—Goldman Sachs, Morgan Stanley, and JPMorgan Chase—2008 bonus payments were substantially greater than the banks' net income. Goldman earned \$2.3 billion, paid out \$4.8 billion in bonuses, and received

\$10 billion in TARP funding. Morgan Stanley earned \$1.7 billion, paid \$4.475 billion in bonuses, and received \$10 billion in TARP funding. JPMorgan Chase earned \$5.6 billion, paid \$8.69 billion in bonuses, and received \$25 billion in TARP funding. Combined, these three firms earned \$9.6 billion, paid bonuses of nearly \$18 billion, and received TARP taxpayer funds worth \$45 billion.")

7. Participants in Government Investment Plan, [http://online.wsj.com/public/resources/documents/st\\_BANKMONEY\\_20081027.html](http://online.wsj.com/public/resources/documents/st_BANKMONEY_20081027.html); Where Bailout Money Goes to Die, <http://www.usnews.com/blogs/flowchart/2009/07/28/where-bailout-money-goes-to-die.html>.

8. 12 U.S.C. §5021 et seq.

9. IFR, §30.2.

10. IFR, §30.16(b)(1).

11. An SEO is a "named executive officer" on the TARP recipient's annual report on a Form 10-K or annual meeting proxy statement. IFR, §30.3.

12. IFR, §30.16(b)(1)(i).

13. IFR, §30.16(b)(1)(ii).

14. IFR, §30.16(b)(1)(iii).

15. IFR, §30.16(b)(1)(iv).

16. IFR, §30.16(b)(v).

17. IFR, §30.16(b)(vi).

18. IFR, §30.10(a)-(b).

19. IFR, §30.10(e)(2).

20. IFR, §30.10(e).

21. IFR, §30.9; IFR, §30.12.

22. IFR, §30.4.

23. IFR, §30.4 through 30.7; IFR, §30.15 .

24. IFR, §30.8.

25. IFR, §30.16(a)(1).

26. IFR, §30.16(a)(2).

27. IFR, §30.16(a)(3).

28. IFR, §30.16(a)(3).

29. IFR, §30.16(a)(4).

30. 378 U.S. 184, 197 (1964).

31. "House Approves 90% Tax on Bonuses After Bailouts," New York Times, March 19, 2009, <http://www.nytimes.com/2009/03/20/business/20bailout.html>.

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