March 20, 2008

Highlights from the Recent Congressional Hearing on CEO Pay and the Mortgage Crisis

On March 7th, the House of Representatives' Committee on Oversight and Government Reform ("the Committee") held a hearing titled "Executive Compensation II: CEO Pay and the Mortgage Crisis." In advance of the hearing date, the Committee released a staff memorandum examining the apparent breakdown between shareholder interests and the compensation and retirement benefits awarded to three prominent CEOs whose companies are involved in the mortgage crisis.[1] This was the second in a series of hearings that focus on executive compensation. The first hearing was held in December 2007, with the Committee examining the role played by compensation consultants in setting CEO pay.

Starting promptly at 10 a.m., the hearing, presided over by the Committee's Chairman - Representative Henry Waxman, was broken into two sessions. Session one, which lasted one hour, provided testimony from individuals with expertise in or experience related to the mortgage crisis. Session two, which lasted close to three hours, provided testimony on CEO compensation. At the beginning of each session, each witness on the panel was permitted the opportunity to provide an opening statement.[2] Members of the Committee were then permitted to ask questions of the panel but were held to a strict time limit.

Key Observations from the Hearing

From a compensation perspective, the key issue addressed during the hearing was whether the executive compensation system operates to ensure CEO accountability for corporate failures. Views on this and related issues were generally divided along party lines, indicating that possible legislative activity related to executive compensation may be very much dependent on the outcome of the November elections.

Areas of reform that may develop based on issues discussed at this hearing include:

1. Re-examination of the definition of "cause" for termination purposes

Executives are often entitled to cash severance compensation and other benefits upon involuntary termination of employment if not for "cause." However, the definition of "cause" used in the

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[1] The three CEOs examined include: Countrywide CEO Angelo Mozilo, former Merrill Lynch CEO Stanley O'Neal, and former Citigroup CEO Charles Prince. See memorandum on the Committee's website at Committee Releases Memorandum on CEO Pay and the Mortgage Crisis :: Committee on Oversight and Government Reform :: United States House of Representatives.

[2] See complete transcript of Chairman's opening statement and witness testimony on the Committee's website at Opening Statement of Chairman Waxman: Committee Holds Hearing on CEO Pay and the Mortgage Crisis :: Committee on Oversight and Government Reform :: United States House of Representatives.

vast majority of employment agreements does <u>not</u> include poor performance.[3] The question arises whether it should? Rep. Waxman addressed this numerous times in the hearing. At one point, he asked, “When companies fail to perform, should they give millions of dollars to their senior executives?” If poor performance warranted termination for “cause,” then much of the payments received by Messrs. Prince and O’Neal (particularly unvested equity holdings) would have been forfeited.[4]

— Pressure may intensify to provide no cash severance and forfeiture of unvested equity in cases of termination for poor performance

— The definition of “cause” may be broadened to include poor performance

  -- However, we would expect that broadening the “cause” definition to include poor performance will be contested vigorously by executives and their counsel and result in an increase in lawsuits related to what constitutes poor performance

— The decision to terminate a CEO based on poor performance or allow a retirement-eligible CEO to retire would still fall to the Board

  -- Many times there is no question that the CEO performed poorly in the current year, but the executive may have performed extremely well over his/her tenure with the company. In these cases, the Board often times encourages the executive to retire early, provided the CEO is retirement eligible

  -- Will Boards have the courage to terminate based on poor performance even if it is provided?

  -- How will “poor performance” be defined?

2. Increased prevalence of “clawback” features

Several members of the Committee questioned why incentive compensation was tied to the *<u>quantity</u>* of loans entered into and seemed to totally ignore the *<u>quality</u>* of those loans. The key question in this regard was “should companies have a way to recapture prior compensation when things go wrong?”

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[3] For “cause” termination is typically limited to certain crimes, violation of restrictive covenants, intentional acts of fraud or other material violations of the law that occur during or in the course of employment.

[4] By far the largest component of Mr. O'Neal's retirement package was $131 million in unvested stock and options. If the board had terminated Mr. O'Neal for “cause,” he would have presumably been required to forfeit these unvested stock and options. Similarly, the Citigroup board allowed Mr. Prince to retain almost $28 million in unvested stock and stock options by letting him retire rather than terminating him for “cause.” See memorandum on the Committee’s website for further detail.

- “Clawback” provisions are increasing in prevalence, but are still a minority practice

- “Clawback” provisions typically focus on recapture of bonus amounts if (i) any fraud or intentional misconduct by an executive played a significant role in the company having to restate all or a portion of its financial statements, or (ii) violation of restrictive covenants

- Should “clawbacks” apply in cases of termination due to poor performance as well as intentional misconduct?

  - It seems that recapturing past bonus amounts due to poor performance in the current year may be double punishment. Absent fraud, the most common way to address the situation is through payment of zero bonus in the present year

3. Continued pressure to reduce or eliminate perquisites

Perquisites came under attack in the Committee’s staff memorandum.[5] In the last year, we have seen these types of arrangements reduced or eliminated in response to a) new proxy disclosure rules and b) continued criticism from shareholders about their non-performance-based nature. Continued negative sentiment may reduce companies’ willingness to provide any perquisites, especially those that do not strongly support an important business objective.

- The Committee memo questioned continued use of office space, secretarial support and car/driver access after retirement and what benefit these perquisites provide to shareholders

  - Is it sensible from a shareholder’s perspective to provide these arrangements following an executive’s retirement from the company?

- Tax gross-ups provided to executives to cover the income imputed for the costs attributable to spousal travel on corporate aircraft also was questioned

4. Closer examination of consultant relationships with management

Although this issue was at the heart of the Committee’s prior hearing in December 2007, it resurfaced only to a limited extent and was specifically focused on consultant use by the CEO

- The key question in this regard was “why should executives be provided access to consultants at the company’s expense in addition to the Committee’s consultant?”

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[5] See memorandum on the Committee’s website at Committee Releases Memorandum on CEO Pay and the Mortgage Crisis :: Committee on Oversight and Government Reform :: United States House of Representatives

— If executives wish to seek advice from consultants and/or attorneys in contract negotiations, who should cover the costs?

-- Management may need access to a consultant for various compensation-related issues, but it seems that the Committee members were surprised that shareholders would have to pay for two consultants (i.e., dueling consultant model)

5. Deferred compensation plans may draw increased attention

Congress continues to look into deferred compensation programs in an effort to restrict the amount of income that can be sheltered from current taxation. Although clearly not severance, large deferred compensation accounts that pay out at times when company performance may be declining is difficult for shareholders to understand. The payment appears to run counter to the pay-for-performance mantra.

— Deferred compensation is actual compensation that has been earned in a prior period. Often times, the media includes the deferred compensation amounts with severance payments when describing exit packages. This fosters anger and confusion among shareholders and the general public

6. Greater scrutiny placed on use of 10b5-1 plans by executives and directors

Rep. Waxman repeatedly questioned whether Mr. Mozilo's stock sales were in the best interests of shareholders. Although the sales were entered into under filed 10b5-1 plans, Rep. Waxman drew attention to the fact that Countrywide announced a large share buyback at the same time that Mr. Mozilo entered into his plan to sell shares.

— The original premise behind 10b5-1 plans was to provide a safe harbor for executives to engage in sales of company stock without fear of insider trading violations

— Plans have drawn increased scrutiny as mentioned by the SEC's Director of Enforcement, Linda Thomsen, in a speech given on March 8, 2007[6]

— Is there ever a good time for executives and directors to sell? Basic financial investment theory mandates diversification of assets; however, executives are under increased pressure to hold considerable shares to illustrate their commitment to the company and alignment with shareholders

— We expect there to be continued discussion with regard to the appropriateness of executive sales via 10b5-1 plans

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[6] Full text of speech can be found on the SEC's website at SEC Speech: Remarks at the 2007 Corporate Counsel Institute; Washington, D.C.; March 8, 2007 (Linda Chatman Thomsen)

7. Increased use of retention ratios and ownership guidelines

The vast majority of Fortune 500 companies have executive ownership guidelines in place. However, the design of these programs differs by company. The most common approach is a multiple of salary requiring executives to own a specified value of equity after which they can sell holdings to meet there individual financial diversification needs. Another approach, used by Merrill Lynch and Citigroup, called a retention ratio, requires executives to retain a specified percentage of any equity awards upon vesting or exercise (e.g., 75% of the net after tax value of their equity holdings) until termination from the company.

- These programs align the interests of executive with those of shareholders over the long-term

- They mitigate significant stock sales by executives and thereby help to ensure accountability if stock price falls

8. Elimination of severance for CEO / Founders

Mr. Mozilo gave up his right to receive $37.5 million in severance and benefits after being called to testify. However, the Committee raised the broader issue of whether his contract should have contained these provisions in the first place.

- In situations where a CEO / Founder holds a material amount of equity in the company, it may not be appropriate to also provide cash severance to the individual

Additional Observation

Another issue that we have observed, tangentially related to issues raised at these hearings, is the disparity in compensation values reported by various publications due to the misuse of compensation terminology. There appears to be a critical need for compensation information to be categorized accurately in the media.

To evaluate the magnitude of compensation packages requires some uniformity in the way compensation elements are classified. Some examples include:

- Voluntary deferral accounts that are distributed to an executive at termination are not "severance" payments. These accounts consist of compensation that has been earned over a number of earlier years, with the payment simply being delayed to a later date. Including this information as "severance" is incorrect and inflates the actual "severance" payments provided, if any

  - Whether the original payments (that were then deferred) were earned *based on performance* is an entirely separate issue

— Vested equity awards and in-the-money option gains are also sometimes grouped in with “severance” payments. This is simply incorrect

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be considered or relied upon as legal advice. General questions may be directed to Lou Taormina in our New York offices at 212-299-3717 or by e-mail at loutaormina@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.