

# Corporate Governance Reform, The Financial Crisis and the Problem of Executive Compensation

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# The Financial Crisis

- The disappearance of investment banks
  - There were five firms at the beginning of the crisis
  - Lehman is bankrupt
  - Bear Stearns and Merrill Lynch have been acquired
  - Morgan Stanley and Goldman Sachs have converted to commercial banks

# The Obama Administration Response



# The Financial Crisis

- The Bailout
  - As of March 27, 2009, Treasury had disbursed \$303.4 billion of the \$700 billion in the Troubled Asset Relief Fund or TARP
  - Most of the funds (about \$199 billion) went to purchase preferred shares of 532 financial institutions

# The Financial Crisis

- Government Intrusion into the Private Sector
  - AIG: Total bailout amount: \$180 billion (although \$30 billion remains undisbursed). Government owns 80% of the shares
  - Citigroup: Received \$52 billion. Half of this amount has been converted into a 34% stock ownership

# The Financial Crisis

- General Motors
  - Treasury will provide about \$30.1 billion
  - Government will receive about 60% of the equity of the reorganized company.
  - Canadian Government will receive 12% of equity and the right to elect one director to the board

# The Role of Executive Compensation

- A view that executive compensation contributed to the problem
  - Much of the compensation came in the form of stock or stock options
  - Short term emphasis on profits

# Highest Paid CEOs in 2007 (Just Before the Financial Crisis)

1. **John Thain, Merrill Lynch, \$83.1 million**
2. Leslie Moonves, CBS Corp., \$67.6 million
3. Richard Adkerson, Freeport-McMoran Copper & Gold Inc., \$65.3 million
4. Bob Simpson, XTO Energy Inc., \$56.6 million
5. **Lloyd Blankfein, Goldman Sachs Group Inc., \$53.9 million**
6. **Kenneth Chenault, American Express Co., \$51.7 million**
7. Eugene Isenberg, Nabors Industries Ltd., \$44.6 million
8. **John Mack, Morgan Stanley, \$41.7 million**
9. Glenn Murphy, Gap Inc., \$39.1 million
10. Ray Irani, Occidental Petroleum Corp., \$34.2 million

# Other Examples: Golden Parachutes

- Stanley O'Neal at Merrill Lynch received \$159 million in connection with his 2007 departure
- Bob Nardelli, the CEO of Home Depot, left in January 2007 with a \$210 million payout despite declining share prices.
- Richard Grasso received a \$140 million deferred compensation pay package in connection with his departure from the New York Stock Exchange.

# US v. The World

According to the Towers Perrin worldwide pay report, U.S. CEOs are paid:

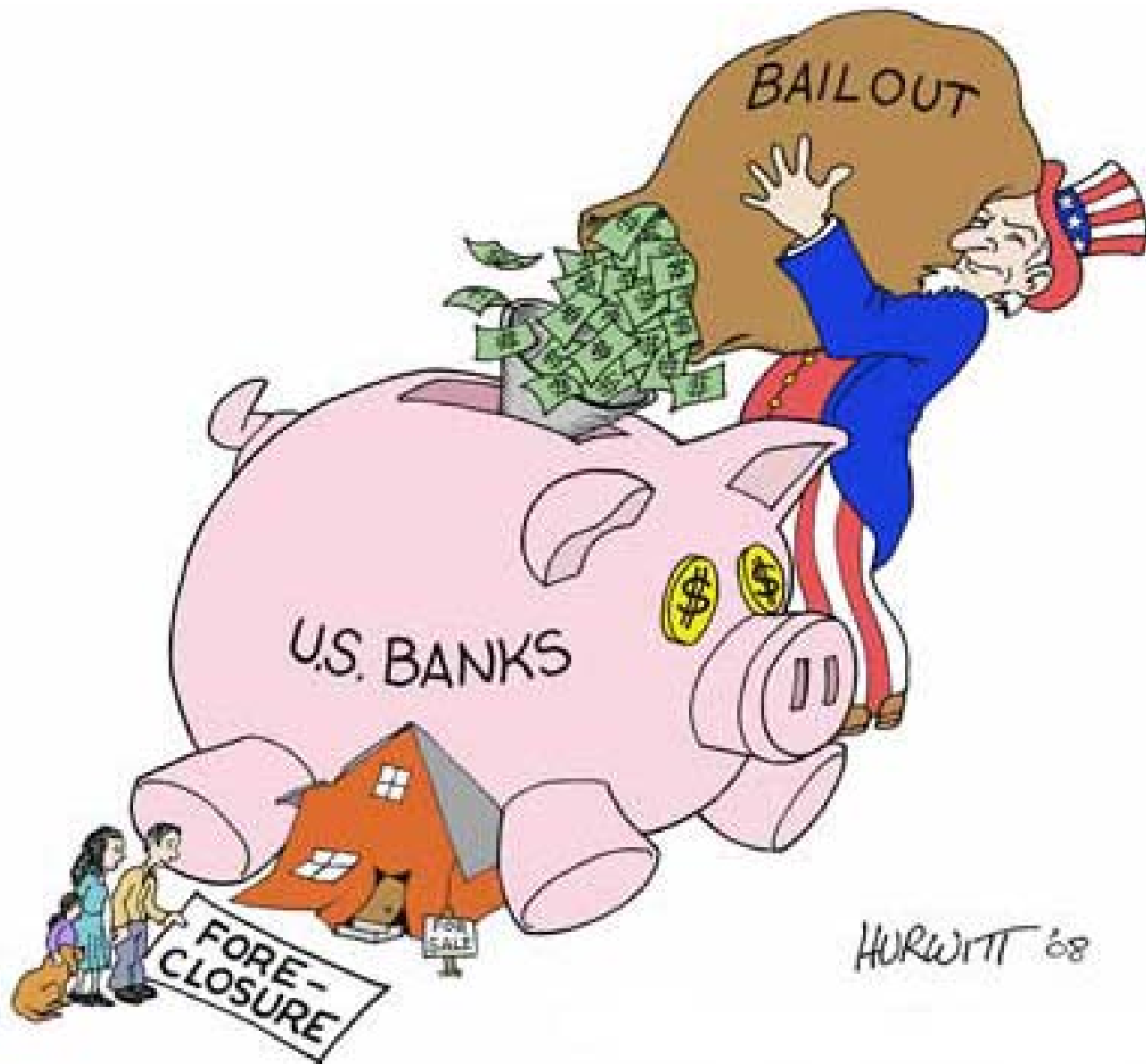
- more than twice as much as Canadian CEOs,
- nearly three times as much as British CEOs,
- four times as much as German CEOs.

- <http://www.pww.org/article/articleprint/3710> (2003)

Name	Fees Earned or Paid in Cash	Stock Awards (a)	Option Awards (b)	All Other Compensation (c)	Total (d)
Lord Browne of Madingley*	\$346,032	—	—	—	\$346,032
John H. Bryan	—	\$389,537	\$296,032	\$10,000	\$695,569
Claes Dahlbäck	—	\$366,059	\$296,032	—	\$662,091
Stephen Friedman	—	\$662,091	—	—	\$662,091
William W. George	—	\$662,091	—	—	\$662,091
Rajat K. Gupta	—	\$662,091	—	—	\$662,091
James A. Johnson	—	\$ 93,505	\$592,064	\$10,000	\$695,569
Lois D. Juliber	—	\$662,091	—	\$ 8,000	\$670,091
Edward M. Liddy**	—	\$675,770	—	\$10,000	\$685,770
Ruth J. Simmons	\$ 75,000	\$592,064	—	—	\$667,064

**Director Compensation:** Goldman's board convened ten times last year. Goldman provides compensation through stock awards. Stock awards are considered director's fees not subject to the compliance rules of the NYSE. The average compensation was \$640,845.

Currently, Goldman's directors are defendants in two suits surrounding their compensation. The suits stem from allegations of undervaluing stock options.



# TARP Limits on Executive Compensation

- Compensation in the US is regulated at the state level
- TARP began federal regulation of compensation by requiring financial institutions:
  - To exclude incentives that encourage “unnecessary and excessive risks that threaten the value of the financial institution”
  - To put in place clawbacks that were designed to recover “any bonus or incentive compensation paid . . . based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate”.
  - From “making any golden parachute payment to its senior executive officer”. Senior executive officer included the CEO, the CFO, and the three most highly compensated executive officers.

# TARP Limits on Executive Compensation

- Only applied to companies taking funds under TARP
- Expired once the funds were repaid
- Did little to reduce executive compensation
- But it was a first step

# Continued Concern over Executive Compensation

- **AIG:**
  - 2008: \$442,000 that an A.I.G. subsidiary spent on a weeklong resort retreat for top sales staff, within days of receiving government aid.
  - April 2009: Paid \$30 million in bonuses to employees

# Monarch Beach Hotel (Location of AIG Party)



# Auto Companies and the Bailout

- Heads of Chrysler, Ford and GM came to Washington in late 2008 to ask for a federal bailout
- They made the mistake of arriving in private aircraft
- GM and Ford owned aircraft; Chrysler leased a plane

# The General Motors Aircraft



GM CEO Wagoner arrived the next time in a Malibu hybrid



# John Thain and His Office Renovation

- In early 2008, Thain spent \$1.2 million while at Merrill Lynch to redecorate his office
  - \$87,000 for an area rug,
  - \$28,000 for four pairs of curtains
  - \$87,000 for a pair of guest chairs

# Limits and the Obama Administration: The Stimulus Bill

- March 2008, Congress adopted the Stimulus Bill. Called for spending \$787 billion to help stimulate the economy
- Contained more severe limits on executive compensation
- Reflected growing political pressure on Congress to seem tough on the companies receiving bailout funds

# Limits and the Obama Administration: The Stimulus Bill

- The amendments imposed strict limits on corporate bonuses
  - The value of the bonuses could not exceed one-third of the total amount of annual compensation.
  - Bonuses could only be paid in the form of “long-term restricted stock” that did not vest until the TARP funds had been repaid.
  - The number of persons affected depended upon the size of the financial institution. It applied to no more than the top 25 officers (only for companies receiving \$500 million or more in bailout money)

# Limits and the Obama Administration: The Stimulus Bill

- Regulated the Board of Directors
  - TARP recipients must also have a compensation committee consisting entirely of independent directors and must review employee compensation plans.
  - The committee must meet at least twice a year “to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the TARP recipient from such plans.”
  - The committee must certify that the reviews took place.

# Limits and the Obama Administration: The Stimulus Bill

- The board must likewise put in place a policy regarding “excessive or luxury expenditures” including:
  - (1) entertainment or events;
  - (2) office and facility renovations;
  - (3) aviation or other transportation services; or
  - (4) other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the business operations of the TARP recipient.

# Limits and the Obama Administration: The Stimulus Bill

- A larger role for shareholders
  - TARP also made mandatory an advisory vote on executive compensation, so called “say on pay.”
  - The vote was not “binding on the board of directors of a TARP recipient,

# Treasury Regulations: The Pay Czar

Most recently development: The appointment of a Pay Czar

- Applies to seven companies receiving “exceptional assistance”. This includes seven firms: AIG, Citigroup, Bank of America, General Motors, GMAC, Chrysler, and Chrysler Financial.
- At some level, the Pay Czar will have power to review compensation paid to all employees.
- The Pay Czar is empowered to deny bonuses and compensation plans found to be inconsistent with taxpayer interests. They cannot be deemed inappropriate, unsound or excessive.

# Obama Administration: Proposed Legislation

- Reform that extends to all companies
- Mandatory say on pay
- Regulation of compensation committees
  - ensure that corporate compensation committees are more independent, similar to requirements for audit committees under the Sarbanes-Oxley Act.
  - pay committees would receive their own authority and funds to hire independent compensation consultants and outside legal counsel.

# Assessment

- These won't work
- The problem is with the board of directors and the standard for setting compensation
- None of these changes affect this approach

# Possible Solutions

- One possibility is to fix the board of directors
  - More authority and greater independence of members
- The problem is the definition of independent
  - Independent directors are not really independent
  - Even “independent directors” have an economic incentive to support management

# Possible Solutions

- Adopt a federal standard for determining compensation
  - Take the authority away from Delaware; leave it to the federal government to determine
  - The federal courts would likely give greater scrutiny to the decisions
  - Unlikely to happen

# The Real Solution: Shareholder Access

- Shareholder access
  - The Securities and Exchange Commission has proposed a rule called “The Access Rule” that would allow shareholders to include their nominees for the board of directors in the company’s proxy statement
  - Effectively this would cause the company to pay some of the costs associated with electing shareholder nominated directors

# Will It Work?

- Business interests are opposed. They have promised to challenge it in court.
- It doesn't make proxy contests cheap
  - Shareholders will still have to pay any additional costs associated with a proxy contest
  - Proxy Advisor
  - Additional communications

# Will it work?

- Shareholder nominated directors will rarely be elected but it will happen
- The best impact will be on those directors who are not challenged
- Other directors will know that if they are excessively deferential to management, they may be challenged. This will probably put downward pressure on executive compensation.