Financial and Economic Crisis – Law Firms

Executive Compensation Under Fire

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Fueled by moral outrage and growing anger in the wake of the global economic crisis, executive compensation practices have taken center stage in corporate America. Public corporations are facing unprecedented scrutiny and calls for reform from Washington, their shareholders, and corporate watchdog groups. The fury over bonuses, golden parachute arrangements, and other executive compensation packages is reaching a fever pitch and driving a spate of new litigation.

Recent Litigation

Perhaps the most well publicized of the recent lawsuits that have been filed regarding executive compensation is the derivative lawsuit filed in Los Angeles County Superior Court on April 1, 2009, against Edward Liddy, the CEO of American International Group, Inc., and a number of its other officers and directors.[1] The complaint in that case alleges that there was "no rational business purpose or justification" for AIG's approval of over $ 1 billion in bonus payments, "including approximately $ 400 million in bonuses to employees in the AIG Financial Products . . . unit responsible for AIG's demise, and $ 57 million in 'retention' pay for employees that AIG had already decided to terminate." The complaint seeks to recover unspecified damages for corporate waste, breach of fiduciary duty, abuse of control, and unjust enrichment.

There was also filed a closely watched derivative lawsuit in Delaware, asserting a claim of corporate waste in connection with the multi-million dollar payment and benefit package paid to Charles Prince, the former CEO and chairman of Citigroup, Inc.[2] While much of the lawsuit against the company's current and former officers and directors arising out of their alleged failure to properly monitor and manage the company's risks and exposure to the subprime market was dismissed in February, the claims for waste with respect to Prince's compensation were permitted to proceed.

The AIG and Citigroup lawsuits are by no means isolated incidents. Under pressure from shareholders and regulators, outgoing Bank of America Corp. CEO Ken Lewis was recently stripped of his chairmanship, agreed to pay back approximately $ 1 million in salary he has received so far for 2009, and will not receive any bonus. At the same time, the SEC and New York State Attorney General's Office are continuing to pursue investigations into the circumstances surrounding Bank of America's acquisition of Merrill Lynch, including whether Bank of America misled shareholders about approximately $3.6 billion in bonuses paid to Merrill Lynch employees.

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Executive Compensation At A Crossroads

Not surprisingly, these issues have ignited a passionate debate. Many corporations have defended their compensation packages as being deeply ingrained in their culture and necessary to ensure that they can attract and retain the best and brightest talent. They suggest that the focus should be on results, including the overall success of the business, and stress the importance of rewarding people who have performed exceptionally. Others respond that those same pay standards have far too often been tied to short-term profits and have encouraged executives to take excessive and imprudent risks. They argue that short-sighted compensation practices contributed in significant part to the financial crisis, and that companies must avoid the mistakes of the past by more closely linking pay to incentives that encourage measurable, long-term performance for the firm and its shareholders.

Whatever side of the debate you find yourself on, there can be no disputing that corporate America is at a crossroads with respect to executive compensation. Earlier this year, the SEC issued proposed regulations that would enhance the disclosure of compensation and corporate governance matters that registered companies are required to provide to shareholders.[3] Legislation introduced in Congress, known as The Corporate and Financial Institution Compensation Fairness Act of 2009, would amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation, often referred to as "say on pay."[4] A study released in September by The Conference Board Task Force on Executive Compensation endorsed proposals for shareholders to have greater input on pay decisions, and also for companies to adopt "claw-back" policies, which would allow for the recovery of amounts paid to executives in the event circumstances change within a specified time-frame following a payment.[5] At the same time, the Federal Reserve is pushing to issue bank compensation rules that would place regulators in the middle of compensation decisions traditionally reserved for boards and their compensation committees, and that would potentially allow the Fed to reject or amend them.[6]

While there are various pros and cons to each of the proposals, the shared goals and fundamental principals of these calls for reform are clear: to increase trust and restore corporate credibility through transparency and accountability, with a closer alignment of company and shareholder interests with those of their executives, and to rein in the compensation practices of the past that many believe have incentivized excessive risk-taking.

The Supreme Court May Be Weighing In

Against this backdrop, the United States Supreme Court will hear argument this month in *Jones v. Harris Associates, L.P.*, a case that may turn out to be the first significant judicial pronouncement on the compensation practices that many have blamed for the current economic climate.

Harris Associates involves a challenge under § 36(b) of the Investment Company Act of 1940 to the fees charged by the investment advisor to a mutual fund. Under § 36(b) "the investment advisor of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation services, or of payments of a material nature, paid by such registered investment company."

Investors in the Oakmark funds sued under § 36(b), alleging that Harris Associates had received excessive fees for its advisory services. Traditionally, when faced with a challenge under § 36(b), most federal courts have applied a standard originally articulated by the United States Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch*.[7] The *Gartenberg* standard looks at whether the investment advisor charged a fee that was so "disproportionately large" or "excessive" that it "bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

On February 27, 2007, the United States District Court for the Northern District of Illinois granted summary judgment in favor of Harris Associates, finding under *Gartenberg* that it had not violated § 36(b). The investors appealed to the United States Court of Appeals for the Seventh Circuit, and the appeal was argued before a three-judge panel on September 10, 2007. On May 19, 2008, the panel, in an opinion authored by Judge Easterbrook, affirmed the district court's dismissal of the investors' claims.[8] However, in so holding, the court effectively rejected the *Gartenberg* standard, finding that it "relied too little on markets" and that § 36(b) "does not make the federal judiciary a rate regulator." According to the panel's opinion, under § 36(b) a fiduciary "must make full disclosure and play no tricks but is not subject to a cap on compensation." At its essence, the court held that the market, not the courts, should be trusted to police advisor fees, and that as long as an investment advisor makes full disclosure of its compensation for advisory services it has satisfied its fiduciary obligations under § 36(b).

But what is perhaps most noteworthy about *Harris Associates* is a strongly worded dissent authored by Judge Posner on August 8, 2008, when the Seventh Circuit voted to deny the investors' petition for a rehearing *en banc*.[9] Judge Posner noted that the original panel based "its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of feeble incentives of boards of directors to police compensation." He opined that disclosure alone is an inadequate standard, and that there is an inherent conflict in a system where directors "are often CEOs of other companies and naturally think that CEOs should be paid well." That conflict, according to Judge Posner, cannot be overlooked even when independent compensation consulting firms are retained "because they are paid not only for their compensation advice but for other services to the firm – services for which they are hired by the officers whose compensation they advised on." Judge Posner reasoned that "[c]ompetiton in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds." Thus, in Judge Posner's view, courts must do more under § 36(b) than merely assess whether full and accurate disclosure of fees has been made.

While some commentators believe that the Supreme Court will narrowly confine its anticipated opinion in *Jones v. Harris Associates, L.P.* to the rather dry issue of the appropriate standard to apply under § 36(b) of the Investment Company Act of 1940, others are looking at Judge Posner's dissent as a harbinger that the Supreme Court's opinion may cast a wider net and have broader implications. It cannot be overlooked that the original panel of the Seventh Circuit heard argument in the context of a very different economic climate, and many believe that the economic analysis and assumptions that ultimately controlled its decision is inconsistent, as Judge Posner noted, with recent evidence of conflicts and abuses in the market that led to excessive executive compensation and contributed to the worldwide recession. Argument before the Supreme Court is scheduled for November 2, 2009, and it is sure to be spirited.

Conclusion

While public companies are certainly not going to abandon all of their past compensation practices altogether, the bottom line in all of this is that change is on the horizion. Although there are no clear rules, there can be little doubt that boards and their compensation committees are facing an increase in pressure to take on expanded responsibilities and to more closely scrutinize and monitor their pay practices. Reform is likely to take shape and emerge sooner rather than later, and may very well threaten to expand legal exposure and liability with respect to compensation matters.

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[1] See Bible v. Liddy, et. al, *Los Angeles County Superior Court, Civil Action No. BC410879.*

[2] See In re Citigroup Inc. Shareholder Derivative Litigation, *Court of Chancery of the State of Delaware, Civil Action No. 3338-CC.*

[3] *The proposed rules are available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf.*

[4] *H.R. 3269, 111th Cong. (2009).*

[5] *A copy of the complete report of The Conference Board Task Force on Executive Compensation is available at http://www.conference-board.org.*

[6] See *Damian Paletta and Jon Hilsenrath, Bankers Face Sweeping Curbs on Pay,* The Wall Street Journal, *September 18, 2009, at A1.*

[7] See Gartenberg v. Merrill Lynch, *694 F.2d 923 (2d Cir. 1982).*

[8] See Jones v. Harris Assocs., *527 F.3d 627 (7th Cir. 2008).*

[9] See Jones v. Harris Assocs., *537 F.3d 728 (7th Cir. 2008).*

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