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Rules on Compensation Packages for Top 25 Executives of Firms Receiving Exceptional Assistance

On October 22, 2009, the Special Master for TARP Executive Compensation, Mr. Kenneth R. Feinberg ("Special Master"), issued rulings on the proposed compensation packages for the top 25 executives of the seven firms receiving exceptional assistance under the Troubled Asset Recovery Program ("TARP") - namely, AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial. These rulings made significant changes to the proposed compensation packages submitted by the firms a few months ago for review and approval by the Special Master.

Although these rulings apply only to the seven firms receiving exceptional assistance, they illustrate the standards and principles that may be extended to other companies as Congress and other government agencies consider whether new rules and standards should be imposed and whether they should be expanded to cover other companies, particularly in the financial services sector. At the very minimum, it seems likely the standards and principles utilized by the Special Master in issuing these rulings may have to be taken into account in some form or fashion in determining best practices for assessing the executive compensation packages for other companies.

Background

In June 2009, the Treasury issued an interim final rule that provides guidance on the executive compensation and corporate governance standards that apply to companies that participate in TARP ("Interim Final Rule").

The Interim Final Rule also established the Office of the Special Master to address the application of these rules to TARP companies and their employees. The Special Master is responsible for interpreting the compensation and corporate governance standards that apply to TARP companies, including the Interim Final Rule and any other applicable guidance.

Among the duties and responsibilities of the Special Master, with respect to TARP companies receiving exceptional assistance are the obligations to review and approve compensation payments and compensation

structures applicable to the top 25 executives. For this purpose, exceptional assistance includes any financial assistance provided under the Program for Systemically Significant Failing Institutions, the Targeted Investment Program and the Automotive Industry Financing Program (special programs within TARP), and any new program designated by the Treasury as providing exceptional assistance. To date, the above named seven firms are those that have received exceptional assistance under TARP. These companies submitted proposed compensation packages to the Special Master earlier this summer for review and approval. The rulings just issued specifically address those proposed compensation packages and make significant changes to them.

The Interim Final Rule indicated that the Special Master should consider the following six principles in reviewing the compensation payments and structures of the companies receiving exceptional assistance - (i) risk, (ii) taxpayer return, (iii) appropriate allocation, (iv) performance-based compensation, (v) comparable structures and payments, and (vi) employee contribution to TARP company value.

Special Master Rulings

In the press release issued by the Treasury announcing the rulings, the Special Master emphasized that the following five principles were applied in making the rulings:

(1) **Align Compensation Practices with Long-Term Value Creation and Financial Stability:** At the outset, the Special Master emphasized that its rulings represent a fundamental transformation from the pay practices of the

past by, among other changes, rejecting cash payments based on short-term performance and restructuring existing "guaranteed" cash payments into stock held for the long-term. By providing that the executives will receive the overwhelming majority of their pay in company stock that may only be sold over the long term, the executives' interests will be aligned with those of the taxpayers and the shareholders.

(2) Significantly Reduce Compensation Across the Board: To break from the pay practices of the past, the Special Master generally reduced compensation across the board - including both cash and total compensation executives can receive. In this regard, the Special Master noted that, on average, it reduced cash compensation by more than 90 percent from 2008 levels, and total compensation, including stock that must be held for the long term, by more than 50 percent from 2008 levels. Specifically, the Special Master approved base salaries of \$500,000 or less for more than 90 percent of the executives and base salaries of more than \$1 million were approved in just three cases - for the new CEO of AIG, as previously announced, and for two employees of Chrysler Financial, which will wind down its operations in the near term and cannot grant employees long-term incentives.

(3) Require Salaries to be Paid in Company Stock Held Over the Long Term: The executives' base salaries will not be paid entirely in cash. Rather, a portion of their base salaries will be paid in the form of vested stock, subject to re-sale restrictions. The Special Master explained that this structure essentially requires the executives to invest a portion of their base salaries in the long-term future of the firms, alongside taxpayers, which should ensure that executives do not have incentives to take the excessive risks that contributed to the financial crisis. In addition, any stock received can only be sold in one-third installments that cannot begin until 2011, unless the Government is repaid its TARP assistance earlier.

(4) Require Incentive Compensation to be Paid in the Form of Long Term Restricted Stock - Contingent on Performance and TARP Repayment: Incentive compensation can be paid only if the executives attain objective, predetermined performance goals established in consultation with the Special Master, and only after achievement of the performance goals is certified by each company's compensation committee, which must be composed solely of directors fully independent from management. In addition, incentive compensation can be provided only in the form of restricted stock that will be paid only if the company repays its TARP obligations and the employee provides at least three years of service to the company after it is awarded.

(5) Require Immediate Reform of Practices Not Aligned with Shareholder Interests: The Special Master emphasized that, in some cases, golden parachutes and supplemental executive retirement plans ("SERPs") have expanded beyond their original purpose and may not enhance the long-term value of the firm or allow shareholders to easily ascertain the full value of the "walkaway" pay an executive will receive when departing the firm. For these reasons, the Special Master's rulings impose tough new restrictions on these types of payments as well as perquisites and other personal benefits.

With respect to golden parachutes, the Special Master noted that the Interim Final Regulations prohibit these payments to the senior executive officers and five most highly compensated employees at all companies participating in TARP. However, the Special Master's rulings go further and prohibit companies from increasing the amount of any golden parachute payable to any of the top 20 most highly compensated executives during 2009.

In a significant departure from current practice, the Special Master concluded that executives should provide for their retirements with wealth based on performance while they are employed, rather than being guaranteed substantial retirement benefits beyond those provided to everyday workers. Based on this position, the Special Master prohibited additional accruals under SERPs and company credits to other non-qualified deferred compensation plans.

In addition, the Special Master concluded that executives, and not companies, should generally pay for the costs of personal expenses, and therefore, generally capped these types of payments at \$25,000, with limited exceptions for unusual circumstances that can be justified to the Special Master.

The rulings issued by the Special Master represent significant changes from current executive pay practices, but apply only to the seven firms receiving exceptional assistance under TARP. However, several members of Congress and the Treasury have indicated that they are considering whether new rules and standards should be imposed and whether they should be expanded to cover other taxpayers. Now that these specific rulings have been issued, it may be much easier to expand them to cover other situations. It is also not clear the extent to which, if any, the standards and principles

utilized by the Special Master will become best practices for the executive compensation packages of other companies, particularly those in the financial services industry.

It is, moreover, not clear how these rulings will impact the executives at the seven firms covered by the rulings. There is speculation that many executives will simply go work for other companies that are not subject to the TARP restrictions. Only time will tell what the ultimate impact of these rulings will be on the executive compensation packages of the seven companies and other firms. AALU will continue to monitor developments in this area.

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