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FDIC Rule Permits Compensation Recoupment from Executives of Failed Financial Firms

On July 7, 2011, the FDIC adopted a final rule under Section 210(s) of the Dodd-Frank Act permitting the government to recoup or "claw back" two years of compensation paid to executives or directors who are "substantially responsible" for the failure of their financial firms.

Background

In the wake of the Lehman Brothers collapse, Congress significantly expanded the Federal Deposit Insurance Corporation's (the "FDIC") liquidation authority to reach beyond banks to other financial institutions. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") appointed the FDIC as receiver for collapsing financial companies that pose a risk to the stability of the U.S. economy. The FDIC's new liquidation authority is a major component of the Dodd-Frank Act, which is designed to promote economic stability and offers regulators an alternative method of winding down firms without the use of politically tumultuous taxpayer bailouts. If appointed as receiver for a failing financial company, the FDIC has broad authority under the Dodd-Frank Act to operate or liquidate the company, sell its assets and resolve its liabilities. As part of this process, Section 210(s) of the Dodd-Frank Act authorizes the FDIC to recoup the compensation of certain current and former executives or directors of failed financial firms who are "substantially responsible" for the failure of their companies. The clawback provision is part of a broader FDIC rule establishing the order in which creditors will be paid upon the government's liquidation of such failing firms. The final rules go into effect on August 15, 2011.

Recoupable Compensation

The new rules permit the FDIC to recoup compensation paid to the executive or director during the two years preceding the date upon which the FDIC is appointed receiver. If the executive or director has committed fraud, however, the two-year time limit will not apply. Compensation is broadly defined under the rules.[1] Virtually all types of remuneration, including cash, equity and other non-cash benefits (such as perquisites and post-employment benefits), will be subject to recoupment. The FDIC would determine the size of the clawback after evaluating the executive's overall role in the firm's failure.

Applicability of the Clawback

In determining whether to rexcoup an executive's compensation, the FDIC will consider how the executive or director performed his duties and also the results of that performance. If the FDIC determines that a current or former executive or director is "substantially responsible for the failed condition" of the company, then the agency may recover the executive's compensation from the preceding two years. An executive or director is "substantially responsible" if he failed (individually or in conjunction with others) to carry out his duties with the skill and care an ordinarily prudent person in a like position would exercise under similar circumstances, and, as a result, materially contributed to the failure of the company. The clawback rule as originally proposed would have used a gross negligence standard, essentially requiring that the executive acted in bad faith or willingly committed a misdeed. However, the FDIC has clarified that the final rule uses an ordinary negligence standard, a lower standard requiring only that the executive reasonably should have known his actions would harm the company.

Presumption of Responsibility

The rules further list certain executives and directors who will be presumptively responsible for the financial condition of the company. Responsibility is imparted onto the executive or director who (i) serves as the company's chairman of the board of directors, chief executive officer, president, chief financial officer or other officer in a similar strategic or policymaking role; (ii) is removed from his position in management (pursuant to other requirements of the Dodd-Frank Act) as a result of his contribution to the company's poor financial performance; or (iii) is adjudged by a court to have breached his duty of loyalty to the company.

Executives will have an opportunity to rebut the presumption of responsibility. The presumption imparted by virtue of the executive's managerial position is rebuttable by a showing that the executive used the requisite skill and care of an ordinarily prudent person. The FDIC may also consider whether the executive exercised his business judgment. The presumptions arising from the executive's removal from management or a judicial determination that the executive breached his duty of loyalty are rebuttable by a showing that the executive did not cause, individually or collectively, a loss to the company that materially contributed to its failure. Moreover, those executives or directors who join a company specifically for the purpose

[1] Section 380.1 of the rules define Compensation to mean "any direct or indirect financial remuneration received from the covered financial company, including, but not limited to, salary; bonuses; incentives; benefits; severance pay; deferred compensation; golden parachute benefits; benefits derived from an employment contract or other compensation or benefit arrangement; perquisites; stock option plans; post-employment benefits; profits realized from a sale of securities of the covered financial company; or any cash or non-cash payments or benefits granted to or for the benefit of the senior executive or director."

of improving its financial condition are exempted from the presumptions if they were employed for this purpose within two years preceding the FDIC's appointment as receiver.

Enforcement

The FDIC anticipates that it will seek recoupment of compensation through the court system. Upon a determination that the statutory criteria are met, the FDIC's staff will request authority from its Board to file an action to recover the compensation. Enforcement may be hindered, however, given the clawback's apparent inconsistency with state wage laws, which typically operate under a higher gross negligence standard and allow for certain defenses. To what extent these new clawback provisions will withstand judicial scrutiny remains to be seen.

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