

WHO DETERMINES WHEN ENOUGH IS ENOUGH? REFOCUSING REGULATORY LIMITATIONS ON BANKS' COMPENSATION PRACTICES

HEIDI MANDANIS SCHOONER*

INTRODUCTION

Imagine bank¹ executives lining their pockets with the hard-earned savings of American depositors. Even worse, envision bank executives raiding the coffers of a bank on the brink of insolvency and taxpayer-financed bailout. These images permeated the popular media and financial press in the wake of the savings and loan crisis of the 1980s. More importantly, these images provided the contextual background for Congress's decision to strengthen the federal banking regulators'² already broad authority to limit banks' compensation³ practices.⁴

* Assistant Professor, Columbus School of Law, The Catholic University of America.

¹ In this article, the term "bank" is used to refer both to commercial banks and savings associations.

² The federal banking agencies are: the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the Federal Reserve Board ("Fed"). The FDIC is the primary federal regulator for state-chartered, commercial banks that are not members of the Federal Reserve System. 12 U.S.C. § 1813(q)(3) (1996). The FDIC also has the ability, under certain circumstances, to bring enforcement actions against any insured bank and its officers, directors and other affiliated professionals. 12 U.S.C. § 1818(t) (1996). The OCC is the primary federal regulator for all nationally-chartered commercial banks. 12 U.S.C. §§ 26, 93a (1996). The OTS is the primary federal regulator for savings institutions. 12 U.S.C. § 1463 (1996). The Fed is the primary federal regulator for bank holding companies and state-chartered, commercial banks that are members of the Federal Reserve System. 12 U.S.C. §§ 248, 1844 (1996). This article uses the terms "regulator" or "agency" to refer to any or all of the four regulators.

³ The term "compensation" is defined in the recently released Interagency Guidelines Establishing Standards for Safety and Soundness as

all direct and indirect payments or benefits, both cash and non-cash, granted to or for the benefit of any executive officer, employee, director, or principal shareholder, including but not limited to payments or benefits derived from an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

60 Fed. Reg. 35,674, 35,679 (1995). For a discussion of the Interagency Guidelines, see *infra* part I.B.2.

⁴ See *infra* parts I-II.

In strengthening the banking regulators' hand, Congress rode the wave of popular opinion. In 1989, Congress granted the Federal Deposit Insurance Corporation ("FDIC") the authority to repudiate contracts,⁵ including contracts relating to compensation, entered into by banks for which the FDIC acted as receiver.⁶ In 1990, Congress passed legislation granting the FDIC the authority to prohibit golden parachute payments⁷ to bank executives and employees.⁸ In 1991, Congress directed the federal banking agencies to adopt regulations prescribing standards for safety and soundness with respect to banks' compensation practices.⁹ Also in 1991, Congress enabled the banking agencies to limit bonuses paid to senior executive officers of certain undercapitalized institutions.¹⁰

Congress's reaction to the possibly abusive compensation arrangements of bank executives came not only in the wake of the savings and loan crisis but also during a time of general economic recession and growing criticism over excessive salaries paid to top corporate executives across all industries, not just bank executives.¹¹ While debate raged, and indeed continues today,¹² over the fairness of multimillion

⁵ See *infra* part III.B.

⁶ The FDIC serves as receiver for failed commercial banks. Prior to December 31, 1995, the Resolution Trust Corporation ("RTC") served as receiver for failed savings associations. The RTC was dissolved on December 31, 1995, and the FDIC took over its role as receiver for all failed depository institutions. 12 U.S.C. § 1441a(m)(1) (1996). The term "receiver" means "receiver, liquidating agent, conservator, commission, person, or other agency charged by law with the duty of winding up the affairs of a bank or savings association or of a branch of a foreign bank." 12 U.S.C. § 1813(j). The FDIC is also the primary federal regulator for state-chartered, federally insured banks that are not members of the Federal Reserve System. See *supra* note 2. The RTC had no regulatory role. See *supra* note 2.

⁷ As discussed at length *infra* part II.B, the statutory definition of a "golden parachute payment" has three basic components: (1) there must be a "payment"; (2) the obligation of the bank to make the payment to the institution-affiliated parties ("IAP") must be contingent on the termination of the IAP's affiliation with the bank; and (3) the payment must be received on or after a date on which the bank is insolvent, a receiver is appointed for the bank, the AFBA determines that the bank is in a troubled condition, the bank has received a rating of four or five under the Uniform Financial Institutions Rating System or the FDIC has initiated a proceeding against the bank to terminate or suspend its deposit insurance. The term "golden parachute payments" does not include payments under certain retirement plans, payments made pursuant to a bona fide deferred compensation plan which the FDIC determines to be permissible and payments made by reason of death or disability.

⁸ See *infra* part II.B.

⁹ See *infra* part I.B.2.

¹⁰ See *infra* part II.A.

¹¹ See Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 937-38 (1993).

¹² See, e.g., DEREK BOK, *THE COST OF TALENT* 98 (1992); ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* 67 (1995); Linda J. Bartis, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 76 (1992); Elson, *supra* note 11,

dollar compensation packages for corporate CEOs, especially during times of massive corporate lay-offs, Congress did relatively little to address the perceived problem in the context of non-bank corporations. Congress passed tax legislation prohibiting corporations from deducting any compensation over one million dollars that is not related to performance.¹³ Perhaps more significantly, the Securities and Exchange Commission ("SEC") adopted a rule requiring public corporations to disclose the compensation paid to top executives and amended its proxy rules to allow shareholder proposals regarding compensation issues on ballots.¹⁴ While scholars and practitioners were quick to offer solutions to the problem of "over compensation,"¹⁵ Congress took no further action that would affect non-bank corporate America.

The changes in the banking laws, however, were dramatic. The banking industry is only beginning to feel their full impact. In 1995 and 1996, the federal banking agencies adopted several regulations implementing the new powers granted by Congress during this period. The federal banking agencies have aggressively interpreted and enforced these new powers. While the insolvencies of the 1980s and early 1990s faded into history, the public's and the regulators' interest in issues of compensation persists.¹⁶ Compensation practices have been blamed, in part, for the very recent and highly publicized losses by Barings and Daiwa banks.¹⁷

at 979; Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1436 (1995); Tom Herman, *Little-Noticed Item in Senate's Budget Alarms Some Firms: Plan Would Limit Tax Break for High Compensation; Opposition Grows Quickly*, WALL ST. J., Nov. 2, 1995, at A4; Joann S. Lublin, *Executive Pay (A Special Report): The Great Divide: CEO Pay Keeps Soaring, Leaving Everybody Else Further and Further Behind*, WALL ST. J., Apr. 11, 1996, at R1; Joann S. Lublin, *Executive Pay (A Special Report): Raking It In: CEO Pay Is Soaring Again, Thanks to Rising Profits, Directors' Pursuit of Outside Talent and Reduced Public Criticism*, WALL ST. J., Apr. 12, 1995, at R1.

¹³ See 26 C.F.R. pt. 1 (1996) (correction to final regulations); 60 Fed. Reg. 65,534 (1995) (final regulations relating to section 162(m) of the Internal Revenue Code, added by the Omnibus Budget Reconciliation Act of 1993). Section 162(m) provides that a publicly-held corporation is denied a deduction for compensation paid to a "covered employee" (includes the CEO, plus the next four highest compensated officers) to the extent that the compensation exceeds \$1,000,000. This deduction limitation does not apply to "performance-based compensation" (remuneration payable solely if: (1) goals are determined by a qualified compensation committee; (2) the terms of the compensation agreement are disclosed to, and approved by, shareholders; and (3) the compensation committee certifies attainment of the goals and other material terms). 60 Fed. Reg. 65,534-35.

¹⁴ Regulation S-K, 17 C.F.R. §§ 229.402, 240, pt. 14 (1996).

¹⁵ See *infra* part IV.D.

¹⁶ See, e.g., Nikhil Deogun, *First Union Takeover of First Fidelity to Bring Terracciano Large Payments*, WALL ST. J., Sept. 5, 1995, at A9C (discussing Mr. Terracciano's pending annual salary and bonus of not less than \$2,000,000, regardless of whether or not he leaves First Union (voluntarily or involuntarily)).

¹⁷ Douglas E. Harris, Senior Deputy Comptroller for Capital Markets, Remarks Before the

The question remains whether the laws passed by Congress, along with the existing powers, and the implementation of the laws by the regulators, are an appropriate response to alleged compensation abuses. This issue is of particular importance in light of the relative lack of regulation over the compensation practices of non-bank corporations—even corporations such as non-bank financial institutions—that are in direct competition with banks. While the banking industry's need to attract and retain talented managers is widely recognized,¹⁸ overreaching restrictions on banks' ability to compensate their employees could impede banks' efforts to compete with their non-bank competitors in attracting the best talent.

In light of these developments, this article examines the banking agencies' authority—both old and new—to regulate banks' compensation practices. The article considers whether the agencies' implementation of their statutory authority is appropriate. In evaluating the appropriateness of regulation in this area, the regulators' mandate to preserve the safety and soundness of banks is balanced against the banks' need to compete in an increasingly competitive marketplace.¹⁹ Also, the banking agencies' activities in this area are viewed against the backdrop of considerable legal and management scholarship addressing issues of compensation.

Fourth City of London Central Banking Conference (Nov. 20, 1995) (available from author); Testimony of Eugene A. Ludwig, Comptroller of the Currency, Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services of the U.S. House of Representatives (Dec. 5, 1995) (available from the author) (Comptroller cited changes to compensation practices as a way to avoid disasters such as those experienced at Barings and Daiwa); Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the European Institute's International Roundtable Seminar (Apr. 28, 1995) (available from author) [hereinafter Roundtable Remarks] (citing compensation practices as one of three issues raised by collapse of Barings resulting from derivatives trading losses); see also James C. Allen, *OCC Moves to Lessen Risk of Emerging Markets Fiascos Series*, 6, 120:246 AM. BANKER, Dec. 22, 1995, at 20; George M. Bollenbacher, *Overcoming the Challenges of Building the "Expert Bank,"* 162:5 AM. BANKER, Jan. 10, 1996, at 16; John R. Dorfman, *Brokerage Firms Take Action to Detect Potential Rogue Traders in Their Midst*, WALL ST. J., Nov. 29, 1995, at C1; *OCC Suggests Review of Trader Compensation Practices*, FIN. TIMES, Jan. 1, 1996, at 25.

¹⁸ See *Resolution Trust Corp. v. Gallagher*, 10 F.3d 416, 422–23 (7th Cir. 1993) (noting that legislative history of Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101–73, 183, indicates an intent to attract quality officers and directors); Joint Advance Notice of Proposed Rulemaking on Standards for Safety and Soundness, 57 Fed. Reg. 31,337 (1992) (stating that safety and soundness standards should not be unclear because of the need to attract qualified management); see also Bollenbacher, *supra* note 17, at 16.

¹⁹ The Comptroller of the Currency described recently the "fundamental tradeoff" for his agency as follows: "[T]o balance safety and soundness concerns with the need to preserve the national banking system in its role as a vital contributor to the economy of our nation." Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the Town Hall of California (July 24, 1995) (transcript available from author).

Parts I, II and III of the article address the sources of the agencies' authority to regulate banks' compensation practices. This authority to regulate banks' compensation practices varies depending upon the financial health of the institution. Predictably, the agencies' powers expand as the health of the institution declines. Part I describes the agencies' authority to regulate the compensation practices of an institution regardless of its financial condition and explores the circumstances under which the agencies are most likely to exercise that authority.²⁰ Part II examines the agencies' authority to regulate the compensation practices of financially troubled institutions and the application of that authority in practice.²¹ Part III analyzes the FDIC's authority, when acting as receiver for a failed institution, to repudiate contracts providing compensation.²²

Following the examination of the agencies' regulatory authority, part IV evaluates, on a comprehensive level, the regulators' approach toward compensation.²³ Part IV concludes that while the banking agencies are appropriately interested in compensation practices because of their potential impact on banks' safety and soundness, the agencies would more effectively regulate in this area by focusing their attention on the decision-making *process* that forms compensation plans rather than attempts to regulate the *content* of such plans. In focusing primarily upon content, the regulators have failed to address adequately the fundamental causes of abusive compensation, i.e., the fact that compensation decisions are made by self-interested members of management. Limitations on the content of compensation plans—without regard for the causes of abusive compensation—could prove detrimental to banks' ability to compete with non-bank rivals for quality leadership and management. To the extent that these limitations cannot be justified as a necessary means for preserving banks' safety and soundness, such an approach does more harm than good.

I. CRADLE TO GRAVE AUTHORITY OVER ABUSIVE COMPENSATION PRACTICES

The banking agencies are said to have "cradle to grave" authority over banks. The term "cradle to grave" invokes the agencies' broad authority over banks from their initial formation until their possible

²⁰ See *infra* notes 24–167 and accompanying text.

²¹ See *infra* notes 168–237 and accompanying text.

²² See *infra* notes 238–87 and accompanying text.

²³ See *infra* notes 288–329 and accompanying text.

demise.²⁴ Part I addresses the agencies' authority to limit compensation practices throughout the life and death of a banking institution. Unlike the powers discussed in parts II and III, the supervisory authority addressed in this part is available to the regulators regardless of the institution's financial health. Although the powers discussed in this part are available to the regulators regardless of a bank's financial status, as a practical matter, these powers are used most often in the cases in which the bank's safety and soundness are in question.

A. Formal Enforcement Powers

Congress vested the banking agencies with formal enforcement powers that assist the agencies in preserving the safety and soundness of insured banks.²⁵ Since the purpose and emphasis of these powers is the preservation of a bank's financial integrity, these formal enforcement powers are available to the banking agencies regardless of the financial condition of the institution.²⁶ While, as discussed below, the agencies have the authority to bring formal enforcement actions for violations of specific laws or regulations, this part focuses on the agencies' broad authority to bring formal enforcement proceedings for "unsafe or unsound banking practices."²⁷ Specific laws and regulations limiting compensation practices are discussed in the remainder of part I and in parts II and III.

1. Statutory Basis

Under the Federal Deposit Insurance Act ("FDIA"),²⁸ the appropriate federal banking agency ("AFBA")²⁹ has the power to bring vari-

²⁴ *Fidelity Fed. Sav. & Loan v. De La Cuesta*, 458 U.S. 141, 145 (1982); *Conference of State Bank Supervisors v. Office of Thrift Supervision*, 792 F. Supp. 837, 840 (D.D.C. 1992).

²⁵ See generally Lawrence G. Baxter, *The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies*, 47 CONSUMER FIN. L.Q. REP. 210 (1993); Alfred J.T. Byrne & Martha L. Coulter, *Safety and Soundness in Banking Reform: Implications for the Federal Deposit Insurer*, 69 WASH. U. L.Q. 679 (1991); Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 187-201 (1995).

²⁶ See, e.g., *Hoffman v. FDIC*, 912 F.2d 1172, 1175 (9th Cir. 1990) (the FDIC may issue a cease and desist order whether or not the institution is insolvent).

²⁷ See *infra* notes 45-79 and accompanying text (discussing "unsafe or unsound banking practices").

²⁸ FIRREA significantly amended the FDIA and expanded the enforcement powers of the federal banking agencies. See 12 U.S.C. §§ 1811-31 (1996).

²⁹ The AFBA for a national bank is the OCC; for a state bank that is a member of the Federal Reserve System, it is the Fed; for a state bank that is not a member of the Federal Reserve System, it is the FDIC; and for a savings institution, it is the OTS. *Id.* § 1813(q). Although the FDIC is the AFBA only for state banks that are not members of the Federal Reserve System, the FDIC

ous formal enforcement actions against banks and their institution-affiliated parties ("IAP"), which include bank officers, directors, employees and certain shareholders.³⁰ The agencies may use any of the following administrative enforcement powers to address abusive compensation practices: cease and desist powers (which can include the authority to order restitution, reimbursement or indemnification); removal from office; prohibition from participation in the banking industry; and civil money penalties.³¹

The AFBA may issue a cease and desist order³² against a bank or an IAP for unsafe or unsound banking practices or violations of any law, rule, regulation or any written agreement entered into with the agency.³³ The cease and desist power includes the authority to require the respondent to make restitution or provide reimbursement, indemnification or guarantee against loss if the respondent was unjustly enriched or acted in reckless disregard of the law, regulations or prior order of the agency.³⁴

retains enforcement authority over any bank or savings association that it insures. *Id.* § 1818(i). The FDIC must first recommend to the AFBA that the agency take enforcement action. *See id.* If the AFBA does not, then the FDIC may bring the enforcement action upon a negative determination by the FDIC Board regarding the safety and soundness of the institution. *Id.* § 1818(i)(2).

³⁰ *Id.* § 1813(u). The term institution-affiliated party also includes, under certain circumstances, certain professionals (e.g., attorneys, appraisers and accountants). *Id.* § 1813(u)(4).

³¹ Orders to cease and desist, to pay civil money penalties and for removal or prohibition may be appealed to the appropriate United States Court of Appeals. *Id.* § 1818(h)(2). This appellate review is governed by Chapter 7 of the Administrative Procedure Act ("APA"). 5 U.S.C. §§ 701-706 (1996). The APA provides that agency action will be reversed only upon a court's finding that the action was not supported by substantial evidence or is otherwise arbitrary and capricious. *Sunshine State Bank v. FDIC*, 783 F.2d 1580, 1584 (11th Cir. 1986) (citing 5 U.S.C. § 706(2)(A)); *First Nat'l Bank of Eden v. Comptroller of the Currency*, 568 F.2d 610, 611 (11th Cir. 1978) (citing 5 U.S.C. § 706(2)(E)); *see also First Nat'l Bank v. Smith*, 610 F.2d 1258, 1264 (5th Cir. 1980).

³² The issuance of the order is preceded by service of a notice of charges and a hearing. 12 U.S.C. § 1818(b)(1).

³³ *Id.* Section 1818(b)(1) provides, in pertinent part, as follows:

If, in the opinion of the appropriate Federal banking agency, any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency, the agency may issue and serve upon the depository institution or such party a notice of charges in respect thereof.

Id.

³⁴ *Id.*

The AFBA possesses means of enforcement that permit the removal of an IAP from office or the prohibition of an IAP from participation in the affairs of the bank. An IAP can be sanctioned for violations of law, regulation, unsafe or unsound practices or breaches of fiduciary duty, if by reason of such violation, practice or breach, the bank suffered, or will probably suffer, financial loss or other damage or the interests of the bank have been, or could be, prejudiced, or the IAP has received financial gain or other benefit and the violation, practice or breach involves personal dishonesty or demonstrates willful or continuing disregard by the IAP for the safety or soundness of the bank.³⁵ An IAP who is subject to a removal or prohibition order is also prohibited from participating in the conduct of the affairs of *any* insured depository institution unless the IAP receives written consent from the agencies.³⁶

Banks and IAPs confront potential liability for three tiers of civil money penalties.³⁷ The first-tier penalty may reach up to \$5000 for each day the violation continues, the second tier is up to a sobering \$25,000 per day, and the third tier is up to an alarming \$1,000,000 per day.³⁸ The first-tier civil money penalty is likely the most potent source of liability. It includes none of the standards of culpability required in the other two tiers (i.e., knowing or reckless conduct).³⁹ The first-tier civil money penalty can be imposed on a bank or IAP for any violation of law, regulation, certain final orders or any written agreement with the agency.⁴⁰

A bank or IAP is liable for a second-tier civil money penalty of up to \$25,000 per day for violating any law, regulation, certain final orders or any written agreement with the agency, recklessly engaging in an unsafe or unsound practice or breaching any fiduciary duty, if such violation, practice or breach is part of a pattern of misconduct, or causes or is likely to cause more than minimal loss to the bank, or results in pecuniary gain to the bank or IAP.⁴¹ Third-tier civil money penalties of up to \$1,000,000 per day⁴² can be imposed on a bank or

³⁵ *Id.* § 1818(c)(1). The statute provides for notice and hearing before removal. *Id.* § 1818(c)(4).

³⁶ *Id.* § 1818(c)(7).

³⁷ 12 U.S.C. § 1818(i)(2). An agency hearing is available if the respondent requests a hearing within 20 days after notice of the penalty. *Id.* § 1818(i)(2)(H).

³⁸ *Id.* § 1818(i)(2).

³⁹ See *infra* notes 41–43 and accompanying text (discussing the statutory requirements for second-tier and third-tier civil money penalties).

⁴⁰ The penalty is \$5,000 "for each day during which such violation continues." 12 U.S.C. § 1818(i)(2)(A).

⁴¹ *Id.* § 1818(i)(2)(B).

⁴² The maximum penalty for a third-tier violation that can be imposed on an IAP is

IAP who *knowingly* violates any law, regulation, certain final orders or any written agreement with the agency, engages in an unsafe or unsound practice, or breaches any fiduciary duty, and knowingly or recklessly causes a substantial loss to the bank or a substantial pecuniary gain or other benefit to the bank or the IAP by reason of such violation, practice or breach.⁴³

2. Application of Formal Enforcement Powers to Compensation Practices

As a matter of practice, the agencies use all their formal enforcement powers to limit banks' compensation practices.⁴⁴ The agencies employ their powers in two ways. First, the agencies target abusive compensation practices as the basis for the initiation of the enforcement proceeding. For example, an agency may claim that payment of an excessive salary to a bank's chief executive officer was an unsafe or unsound banking practice that serves as a statutory basis for the cease and desist proceeding. Second, the agencies bring cease and desist proceedings on the basis of violations of law or unsafe or unsound banking practices that may or may not include allegations of abusive compensation practices, but incorporate in the cease and desist order limitations on the bank's ability to make compensation determinations. The following text discusses the agencies' use of the formal enforcement powers in these two distinct manners.

a. *Compensation Arrangements that Constitute Unsafe or Unsound Banking Practices*

While violations of specific laws or regulations may serve as the basis for a formal enforcement proceeding,⁴⁵ the agencies also have at their disposal the general principle of unsafe or unsound banking practices as a basis for such proceedings.⁴⁶ The agencies often utilize

\$1,000,000; for a bank, the maximum penalty is the lesser of \$1,000,000 or one percent of the bank's total assets. *Id.* § 1818(i)(2)(D).

⁴³ *Id.* § 1818(i)(2)(C). A director may also be subject to a third-tier civil money penalty for knowingly breaching any fiduciary duty and knowingly or recklessly causing a substantial loss to the bank or a substantial pecuniary gain or benefit to the director by reason of breach. *Id.*

⁴⁴ The agencies appear to use the cease and desist power most in addressing these issues. Although, when the compensation abuses involve self-dealing the agencies are likely to utilize their power to remove IAP or prohibit participation in the industry. See *infra* text accompanying notes 72-79 (discussing cases involving allegations of self-dealing).

⁴⁵ Particular laws or regulations limiting compensation practices are discussed *infra* parts I.B, II.

⁴⁶ "Unsafe or unsound banking practices" is the statutory trigger for each of the formal enforcement proceedings discussed *supra* part I, except first-tier civil money penalties.

unsafe or unsound banking practices as the statutory basis for enforcement proceedings targeting compensation practices.

The term "unsafe or unsound banking practices" has never been defined by Congress, but the courts generally conclude that the phrase means "conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder."⁴⁷ Although courts generally defer to the agencies in the interpretation of the phrase,⁴⁸ there is one significant judicial limitation on this otherwise broad principle. In *Gulf Federal Savings and Loan Ass'n v. Federal Home Loan Bank Board*, the United States Court of Appeals for the Fifth Circuit concluded that the principle of unsafe or unsound banking practices was limited to "practices with a reasonably direct effect on [a financial institution's] financial soundness."⁴⁹ The Third and Ninth Circuits have cited favorably the *Gulf Federal* limitation.⁵⁰ Therefore, any analysis of whether conduct constitutes unsafe or unsound banking practices should include an analysis of whether the practices have a reasonably direct effect on the bank's financial integrity.

⁴⁷ This definition was originally adopted by the Eighth Circuit; the court attributed the wording of the definition to the Comptroller of the Currency. *First Nat'l Bank of Eden v. Department of the Treasury*, 568 F.2d 610, 611 n.2 (8th Cir. 1978) (per curiam). The following decisions rely on the definition provided in *Eden*: *In re Seidman*, 37 F.3d 911, 927 (3d Cir. 1994); *Northwest Nat'l Bank v. United States*, 917 F.2d 1111, 1115 (8th Cir. 1990); *First Nat'l Bank v. Comptroller of the Currency*, 697 F.2d 674, 685 (5th Cir. 1983); *First Nat'l Bank v. Smith*, 610 F.2d 1258, 1265 (5th Cir. 1980).

Some courts rely upon an alternative, but virtually identical, definition, which defines "unsafe or unsound banking practices" as "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." See, e.g., *Seidman*, 37 F.3d at 926-27; *Simpson v. OTS*, 29 F.3d 1418, 1425 (9th Cir. 1994); *MCorp Fin., Inc. v. Board of Governors of the Fed. Reserve Sys.*, 900 F.2d 852, 863 (5th Cir. 1990). The language of this alternative definition is traced to a memorandum written by a former chairman of the Federal Home Loan Bank Board. See *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Comm. on Banking and Currency*, 89th Cong., 2d Sess. 50 (1966); 112 CONG. REC. 26,474 (1966) (memorandum submitted by John Horne, Chairman of the Federal Home Loan Bank Board). For a complete discussion of the definition of "unsafe or unsound banking practices," see Schooner, *supra* note 25, at 187-201.

⁴⁸ *Franklin Sav. Ass'n v. Director, OTS*, 934 F.2d 1127, 1145-46 (10th Cir. 1991), *cert. denied*, 503 U.S. 937 (1992); *Smith*, 610 F.2d at 1264; *Independent Bankers Ass'n of Am. v. Heimann*, 613 F.2d 1164, 1168-69 (D.C. Cir. 1979).

⁴⁹ *Gulf Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982).

⁵⁰ *Seidman*, 37 F.3d at 927; *Hoffman v. FDIC*, 912 F.2d 1172 (9th Cir. 1990). The agencies, however, have not necessarily embraced the decisions' limitation on unsafe or unsound banking practices. See generally Schooner, *supra* note 25, at 193-94.

The following is a discussion of the common categories of cases⁵¹ in which compensation practices give rise to agency action based upon unsafe or unsound banking practices. The first category involves cases in which the agencies claim that the amount of the compensation paid was an unsafe or unsound banking practice. These cases involve claims that the compensation is "excessive." The second category involves cases in which the incentive provisions of an employment contract, e.g., bonus payments, give rise to a claim of unsafe or unsound banking practices. These cases do not necessarily focus on the amount of the compensation paid, but rather the form and method of payment. The third category of cases involves self-dealing transactions as unsafe or unsound banking practices. These cases tend to focus on the circumstances surrounding the underlying decision to pay compensation to a bank employee.

1. Amount of Compensation as an Unsafe or Unsound Banking Practice

A common agency claim of unsafe or unsound banking practices in the compensation area involves the agencies' characterization of the amount of compensation arrangements as "excessive."⁵² The following discussion first examines the agencies' factual conclusion that compensation is "excessive," and then explores the application of such facts to the principle of unsafe or unsound banking practices.⁵³

⁵¹ Of course, individual cases could fall into more than one of the categories listed.

⁵² An often cited Eighth Circuit case confirms that the payment of "excessive" salaries and bonuses can constitute an unsafe or unsound banking practice. *Eden*, 568 F.2d at 611. This case provides no indication of the OCC's rationale for determining that the compensation was excessive.

⁵³ Because many enforcement cases are settled by consent, with little public record of the underlying facts or agency analysis, it is often difficult to assess either the agencies' determination that the compensation was "excessive" or the determination that "excessive" compensation constitutes an unsafe or unsound banking practice. For examples of cease and desist orders entered by consent of the respondents which include allegations of "excessive" compensation as unsafe or unsound banking practices but do not provide an analysis as to the reasons for the legal conclusion, see *Corporate Bank*, FDIC-94-54b, FDIC Enforcement Decisions and Orders ¶ 10,975, C-3646, C-3646 (May 4, 1994) (operating with an employment agreement and a settlement agreement providing for an excessive amount of severance pay is unsafe or unsound); *Corporate Bank*, FDIC-93-31b, FDIC Enforcement Decisions and Orders ¶ 10,958, C-3615, C-3617 (Mar. 15, 1994) (operating with employment agreements providing for excessive amounts of severance pay is unsafe or unsound); *Michael S. Lang*, No. AP 93-32, 1993 OTS DD LEXIS *32 (Apr. 27, 1993) (Decision and Order) (paying "improper and excessive dividends, bonuses and compensation"); *Bank of Walnut*, FDIC-91-369b, FDIC Enforcement Decisions and Orders ¶ 10,647, C-2729, C-2731 (Sept. 29, 1992) ("[o]perating in such a manner as to provide excessive compensation to [two bank officials]" is unsafe or unsound); *Green Mountain Bank*, FDIC-92-48b (Feb. 14, 1992) ("maintaining a director deferred compensation plan providing excessive compensation for certain directors" is unsafe or unsound), available in WESTLAW, FFIN-FDIC Database;

With regard to the determination that compensation is "excessive," the agencies often make comparisons of the questioned compensation to both external market factors and internal financial resources. For example, the agencies compare the compensation paid by the respondent bank to what other banks pay for similar services.⁵⁴ Similarly, the agencies may relate the compensation to the fair market value of the services rendered.⁵⁵ Moreover, the agencies relate the amount paid to the bank's financial condition, i.e., the bank's net losses during the same period.⁵⁶

Western Community Bank, FDIC-91-90b, FDIC Enforcement Decisions and Orders ¶ 10,210, C-939, C-940 (Apr. 3, 1991) (operating with consulting agreements that provide \$125,000 payments to two bank officials "over a period of three years for services relating to the operation of the Bank's consumer finance division" is unsafe or unsound); Desert Sun Bank, FDIC-90-175b, FDIC Enforcement Decisions and Orders ¶ 10,109, C-522, C-524 (Aug. 31, 1990) ("operating with a consulting agreement between the Bank and its President and Chief Executive Officer which provide [sic] for excessive life insurance benefits and compensation upon retirement" is unsafe or unsound); Chireno State Bank, FDIC-90-32b, FDIC Enforcement Decisions and Orders ¶ 10,059, C-292, C-293 (Mar. 30, 1990) ("paying excessive committee fees to directors" is unsafe or unsound).

⁵⁴ In one case, the FDIC found that the bank's payment of an excessive management fee in the amount of \$276,300 was an unsafe or unsound banking practice. *In re* * * *, FDIC Enforcement Decisions and Orders ¶ 5003, A-25, A-35 (July 14, 1980). In reaching this conclusion, the FDIC adopted the decision of the Administrative Law Judge ("ALJ") in the case. The ALJ concluded that the bank was paying "considerably more for management services than most banks in the state in spite of its poor financial condition." *Id.* at A-30.

⁵⁵ See Bay Bank & Trust Co., FDIC-93-2202b, FDIC Enforcement Decisions and Orders ¶ 10,945, C-3585, C-3586 (Feb. 11, 1994) (paying compensation "in excess of the reasonable compensation for such services both in relation to the Bank's ability to pay such compensation and in relation to the fair market value of the service rendered or to be rendered to the Bank" was an unsafe or unsound banking practice). *Cf.* * * *, FDIC Enforcement Decisions and Orders ¶ 5003, A-25, A-30 (July 14, 1980) (rejecting bank's argument that ALJ's analysis failed to take into consideration value of services rendered and finding that bank could not afford fee "regardless of the value of the services").

⁵⁶ Capital Bank, FDIC-91-60b (Nov. 4, 1991) (ALJ's decision) (concluding that the payment of bonuses to two senior executive officers during a time when the bank had negative income and a poor capital position was an unsafe or unsound banking practice), available in WESTLAW, FFIN-FDIC Database; * * *, FDIC Enforcement Decisions and Orders ¶ 5003, at A-35 (recommending that FDIC conclude that bank's net loss of \$156,900 after taxes during three year period was "caused primarily" by payment of excessive management fee during same period); see also Richard D. Donohoo, FDIC-92-250e, FDIC-92-251e, and FDIC-92-252k, FDIC Enforcement Decisions and Orders ¶ 5225, A-2583-84 (July 5, 1995) (golden parachute contracts were unsafe or unsound banking practices where such contracts represented a liability for the bank of 22% of the bank's equity capital).

Several consent orders contain language that supports the conclusion that the FDIC views the bank's financial condition as a key element in determining whether compensation is excessive. See, e.g., Somersworth Bank, FDIC-91-315b (Oct. 7, 1991) ("paying excessive salaries, bonuses, and/or cash dividends in relation to the Bank's net income and/or capital position"), available in WESTLAW, FFIN-FDIC Database; Midcounty Bank & Trust Co., FDIC-90-232b, FDIC Enforcement Decisions and Orders ¶ 10,127, C-608, C-609 (Nov. 1, 1990) ("paying excessive cash bonuses and otherwise inadequately controlling overhead expenses in relation to the bank's

While the agencies' decisions and orders provide little guidance as to the reasoning supporting the conclusion that excessive compensation can be an unsafe or unsound banking practice, the agencies' utilization of these comparisons in cases involving claims of "excessive" compensation is consistent with the definition of unsafe or unsound banking practices generally adopted by the courts.⁵⁷ Comparison of the compensation in question to external factors such as the fair market value of the services or the amounts paid by other, similarly situated banks, could satisfy the part of the definition that requires that the conduct be "contrary to accepted standards of banking operations."⁵⁸ The fact that the conduct is contrary to accepted standards, however, is not alone enough to satisfy the definition. The conduct must also be such that "might result in abnormal risk or loss to the banking institution."⁵⁹ Those cases that relate the excessive compensation to the bank's net losses during the same period seem to address that part of the definition.

The cases in which the agencies tie the abusive compensation practices to the bank's net losses⁶⁰ seem to meet the *Gulf Federal* requirement that unsafe or unsound banking practices have a "reasonably direct effect on [a financial institution's] financial soundness."⁶¹ Presumably, however, in some cases involving excessive compensation or other kinds of abusive compensation practices, the *Gulf Federal* limitation, if followed by the agencies or adopted by the reviewing court, may prove problematic for the agencies. Certainly, if the respondent bank is already financially troubled, an agreement to pay "excessive" compensation to bank officials has the potential to threaten the bank's solvency. Rarely, however, would excessive compensation arrangements—even the most abusive—threaten the insolvency of a financially healthy institution.

ii. Incentive Provisions as an Unsafe or Unsound Banking Practice

Like many other businesses, banks often utilize financial incentives to attract, retain and motivate their employees. These incentives

net income and/or capital position"); Norwood Co-op. Bank, FDIC-90-208b, FDIC Enforcement Decisions and Orders ¶ 10,121, C-571, C-572 (Oct. 12, 1990) ("paying excessive cash bonuses and otherwise inadequately controlling discretionary overhead expenses in relation to the Bank's net income and/or capital position").

⁵⁷ See *supra* notes 45-56 and accompanying text.

⁵⁸ See *supra* text accompanying note 47.

⁵⁹ See *supra* text accompanying note 47.

⁶⁰ See *supra* note 56 and accompanying text.

⁶¹ See *supra* text accompanying note 49.

take many forms. For example, a bank might implement a bonus plan tied to certain indicators of productivity to encourage bank employees to work hard. Other examples include a bank's execution of employment contracts with certain executives that ensure that the executives will receive a lump sum of cash if they are terminated within a certain period without cause. These contracts are designed to facilitate banks' efforts to attract or retain talented management even in the face of an impending merger (in which case current management are likely to lose their jobs) or impending insolvency (in which case no jobs are left). Particularly in recent years, the agencies have targeted the incentive provisions of employment contracts as unsafe or unsound banking practices.⁶² An obvious example of an incentive plan that would constitute an unsafe or unsound banking practice is a bank's agreement to pay commissions to its lenders based on the size of the loans made where the individuals approving the loans (and receiving the commissions) are also the individuals performing the credit underwriting.⁶³ This would create an incentive for loan officers to agree to lend the bank's money without regard, or with little regard, for the credit quality of the loan because of the commissions paid.⁶⁴

Many cases in this area involve the termination provisions of an employment contract. In the FDIC decision, *In re Ronald L. Blunt*, the bank executed an employment agreement with a bank employee which had no provision for termination for cause and did not allow the bank to terminate the employee's compensation for failure to perform or provide services.⁶⁵ The FDIC found the bank's execution of the agree-

⁶² These cases are similar to the "excessive" compensation cases discussed *supra* part I.A.1. because they also deal with the terms of the employment contract. They are different, however, in that the focus is not on the amount paid, but on what events trigger payment.

⁶³ See, e.g., John Henderson, Jr., No. AP 95-22, 1995 OTS DD LEXIS, at *9 (Apr. 12, 1995) (Notice of Charges). The OTS alleges that "[a] compensation arrangement was an unsafe or unsound practice because it resulted in the loan originators receiving a direct and significant benefit from approval of . . . loans they originated and greater compensation for larger loans, while, at the same time, allowing them to have a substantial role in loan underwriting and loan administration." *Id.* at *53.

⁶⁴ A reasonable analogy can be drawn from the concerns regarding the practices of paying traders in the Barings and Diawa bank disasters. See, e.g., Ludwig, Roundtable Remarks, *supra* note 17; *Hearings Before the Subcomm. on Financial Institutions and Consumer Credit of the Comm. on Banking and Financial Services of the U.S. House of Representatives* (Dec. 5, 1995) (testimony of Eugene A. Ludwig, Comptroller of the Currency); Harris, *supra* note 17; see also Allen, *supra* note 17; Dorfman, *supra* note 17, at C1; *OCC Suggests Review of Trader Compensation Practices*, FIN. REC. REP., Jan. 1, 1996, at 25.

⁶⁵ Ronald L. Blunt, FDIC-93-24c&b, FDIC Enforcement Decisions and Orders ¶ 5210, A-2391 (Jan. 4, 1994).

ment to be an unsafe or unsound banking practice.⁶⁶ The FDIC's decision and order provide little insight into the agency's analysis of the facts of this case.⁶⁷ Applying the definition of unsafe or unsound banking practices, one could reasonably assume that employment contracts with such woefully deficient termination provisions are "contrary to accepted standards of banking operations"⁶⁸—meeting the first part of the definition of unsafe or unsound banking practices. The second part of the definition, i.e., conduct that "might result in abnormal risk or loss to the banking institution,"⁶⁹ appears satisfied since the employment contract allowed Blunt to continue to receive salary and benefits despite the fact that Blunt had, among other things, been prohibited from participating in the banking industry. The risk or loss to the bank is perhaps abnormal because of the ongoing nature of the loss—the bank was obligated to continue to pay Blunt no matter what he did. There is no way to determine whether the facts of this case are consistent with the *Gulf Federal* requirement that the conduct must have a "reasonably direct effect on [a financial institution's] financial soundness."⁷⁰ As discussed above, this determination will depend upon the financial condition of the bank.⁷¹

iii. Self-Dealing as an Unsafe or Unsound Banking Practice

Perhaps the most serious compensation cases involve situations in which the agencies allege that bank executives put their own interests before the banks' in making decisions to set their own compensation.⁷²

⁶⁶ *Id.* at A-2392. In addition to ordering the bank to rescind the employment agreement, the FDIC ordered Blunt to pay restitution in the amount of all unearned compensation. *Id.* at A-2393. For examples of cease and desist orders entered by consent that find operation with an employment agreement containing "imprudent termination provisions" is an unsafe or unsound banking practice, see Corporate Bank, FDIC-94-54b, FDIC Enforcement Decisions and Orders ¶ 10,975, A-3646 (May 4, 1994); Corporate Bank, FDIC-93-31b, FDIC Enforcement Decisions and Orders ¶ 10,958, A-3615 (Mar. 15, 1994).

⁶⁷ The decision merely states that the Board adopts the ALJ's conclusion that this was unsafe or unsound. *Id.*

⁶⁸ See *supra* text accompanying note 47.

⁶⁹ See *supra* text accompanying note 47.

⁷⁰ See *supra* text accompanying note 49.

⁷¹ See *supra* text accompanying notes 45-67.

⁷² A bank's pending failure apparently provides an opportune time for such problems to arise. See, e.g., United Sav. Ass'n of Tex., 1995 OTS DD LEXIS 29 (Dec. 26, 1995) (Notice of Charges) (directors and officers of failing thrift initiated lavish bonus and severance plans); Robert Gillam, 1994 OTS DD LEXIS 39 (Sept. 30, 1994) (Decision and Order) (CEO of insolvent thrift received \$177,000 plus other benefits and caused board to establish \$300,000 legal defense fund without regulatory approval).

This conduct is often characterized as self-dealing or a breach of fiduciary duty.⁷³ In *Hoffman v. FDIC*,⁷⁴ the United States Court of Appeals for the Ninth Circuit reviewed the FDIC's issuance of a cease and desist order that directed Harold A. Hoffman, president of Alaska Continental Bank, to repay almost \$62,000 that he had received in a buyout of his employment contract with the bank. The court agreed with the FDIC's finding that, given the ailing condition of the bank, this was an unsafe or unsound banking practice and a breach of fiduciary duty.⁷⁵ The court explained that given the bank's precarious financial condition, "it was hardly prudent to decide that the best thing for [the bank] and its assets was to buy out [the director's] contract, because he had decided to abandon a rapidly sinking ship."⁷⁶

⁷³ For examples of compensation cases in which the unsafe or unsound banking practices constituted a breach of fiduciary duty or self-dealing, see *Jameson v. FDIC*, 931 F.2d 290, 291 (5th Cir. 1991) (bank vice president's receipt of bonus not authorized by bank's board and his concealment of bonus on the bank's records was breach of fiduciary duty); Richard D. Donohoo, FDIC-92-250e, FDIC-92-251e, and FDIC-92-252k, FDIC Enforcement Decisions and Orders ¶ 5225, A-2571, A-2584 (July 5, 1995) (approval of golden parachute contracts was breach of fiduciary duty where beneficiaries of such contracts voted for their approval and where there was no valid business purpose for contracts); Stephens Sec. Bank, FDIC-89-234b, FDIC Enforcement Decisions and Orders ¶ 5168, A-1782, A-1790 (Aug. 9, 1991) (bank chairman's receipt of loan origination fees was self-dealing); Gilbert D. Hill, OCC EA No. 582, 1991 OCC Enforcement Decisions LEXIS 345 (Apr. 16, 1991) (Notice of Assessment of Civil Penalties) (CEO, CEO's spouse, and board chairman paid and/or received excessive salaries and bonuses, fees, and other unsubstantiated payments; CEO also withdrew \$60,000 from deferred compensation plan without board authorization); Bank of Salem, FDIC-89-229b (Feb. 28, 1991) (bank chairman's practice of conditioning loan approvals and extension on his receipt of fixed fee was breach of fiduciary duty), available in WESTLAW, FFIN-FDIC Database. See generally Schooner, *supra* note 25, at 207-08 (discussing breaches of fiduciary duty as unsafe or unsound banking practices).

⁷⁴ 912 F.2d 1172, 1173 (9th Cir. 1990).

⁷⁵ *Id.* at 1174.

⁷⁶ *Id.* at 1175. The court rejected the director's argument that he should have been allowed to show that the bank was not insolvent at the time of the payment, since at the time "it was most apparent that [the bank's] assets must be preserved." *Id.* It is important to bear in mind that a bank officer's attempts to protect his or her own interests when his or her bank is in a troubled condition is not always subject to regulatory sanction. In a decision conspicuously limited to its facts, the Board of the FDIC rejected the FDIC Enforcement Counsel's claim that a bank executive engaged in unsafe or unsound banking practices by participating in a compensation arrangement that entailed the escrow of severance benefits on the executive's behalf. Pettinari, FDIC-91-284b, FDIC Enforcement Decisions and Orders ¶ 5188, A-2131, A-2131 (Nov. 17, 1992). In Pettinari, the respondents entered into employment agreements which provided continued salary and benefits if their employment contracts were terminated by the bank without cause or by the respondents with cause. *Id.* at A-2132. In addition, the bank's board created an escrow account at another financial institution, funded with bank assets, to provide the severance benefits. *Id.* On July 3, 1990, one of the respondents was informed that the bank would be closed on July 6, 1990. *Id.* On July 6, 1990, the escrow accounts were closed and checks were issued to the respondents in the amount due under their employment agreements. *Id.* The board's decision rejecting an order of restitution indicates that normally the conduct surrounding this case would be problematic and indicates that it is only the special circumstances of this case that caused the

Similarly, in *Magee v. Greenspan*,⁷⁷ the Federal Reserve (the "Fed") alleged that Magee, the bank's chief executive officer and chairman of the board, paid himself \$455,450 in addition to his salary from a miscellaneous expense account without approval of, or disclosure to, the bank's board of directors.⁷⁸ It is difficult to conceive of a clearer case of a bank executive putting his own interests before the bank's in making decisions regarding his own compensation.⁷⁹ The Fed sought to remove Magee from office and the court denied his motion for preliminary injunction of the proceedings.

b. *Limits on Compensation Practices in Cease and Desist Orders*

Whether or not compensation practices form the basis of the enforcement proceedings, such practices can be implicated in the remedial measures imposed on a bank in a cease and desist order. For example, an agency might bring an enforcement action alleging that lax management and lending practices constituted an unsafe or unsound banking practice. Despite the fact that compensation practices may or may not have been involved in the allegations,⁸⁰ the agency may include corrective measures which address issues of compensation in the cease and desist order.⁸¹ These corrective measures, aimed toward compensation practices, often appear in conjunction with other meas-

FDIC Board to dismiss the charges. *Id.* at A-2133. The decision did not delineate the special circumstances involved. *See id.*

⁷⁷ 808 F. Supp. 847 (D.D.C. 1991).

⁷⁸ *Id.* at 848. The Fed also alleged that Magee arranged for Gaylon Lawrence, a management consultant to the bank, to receive \$266,100 over the payment set in his consulting contract. *Id.*

⁷⁹ *See also* *Simpson v. OTS*, 29 F.3d 1418, 1425 (9th Cir. 1994) (relying, in part, upon *Hoffman*). In *Simpson*, the OTS charged that Simpson's acts—among other things, making a profit-sharing distribution (totalling \$529,500) to himself (of \$105,000) and other officers and managers, when no profits should have been distributed—constituted willful disregard for the thrift's safety and soundness and a breach of fiduciary duty. *Id.* at 1421. The court found inapplicable Simpson's claim that the thrift remained solvent at all times. *Id.* at 1423. "The unsound business practices committed by Simpson threatened Cascade's solvency by improperly dissipating its assets, thereby weakening its financial stability and undermining the interests and confidence of Cascade's depositors." *Id.*

⁸⁰ As discussed *supra* note 53, because so many enforcement actions are settled by consent, often it is difficult to determine what types of activities led to the agencies' initiation of the proceedings. The cases discussed in this part were virtually all settled by consent and may or may not have involved allegations concerning compensation. The preamble of the consent order will typically summarize the allegations. These summaries, however, are generally phrased in such broad terms that little is revealed regarding the underlying facts of the case.

⁸¹ The banking agencies have broad discretion in fashioning appropriate remedies. *Junco v. Conover*, 682 F.2d 1338, 1343 (9th Cir. 1982); *see also* *First State Bank v. FDIC*, 770 F.2d 81, 82 (6th Cir. 1985) (FDIC's decision to issue cease and desist order is reviewed under arbitrary and capricious standard).

ures targeting poor management practices and high overhead expenses. The following text details the corrective measures addressing compensation: first, those measures addressing a bank's existing compensation practices and, second, those aimed at shaping a bank's future practices.⁸²

i. Orders Limiting Existing Bank Compensation Practices

The types of corrective measures involving banks' existing compensation practices in cease and desist orders range from the very broad to the very specific. Usually, the limitations are directed towards senior management or the board of directors. An example of a broad corrective measure is the agencies' limitation of a bank's ability to enter into employment agreements.⁸³ Another broad measure involves the agencies' imposition of limitations on salaries or compensation packages offered to bank employees. For example, the agencies may require the prior written consent of the agency for any increase in compensation,⁸⁴ or they may condition salary increases over a certain amount on the prior consent of the agency,⁸⁵ or they may ban increases

⁸² Any given cease and desist order may, of course, contain any number of limitations on compensation practices. The discussion below is intended to provide a synthesis of the types of limitations that typically appear, alone or in concert. Some of the cases cited in this part involved compensation practices as part of the allegations that served as the factual basis for the initiation of the proceedings, but many of the cases did not explicitly mention compensation practices as part of the factual basis.

⁸³ Bank of New England-West, Nat'l Ass'n, OCC EA No. 77, 1990 OCC Enforcement Decisions LEXIS 58, at *5 (May 11, 1990) ("Prior to entering into any new employment . . . agreements, or renewing or extending any such existing agreements with the Bank's senior officers . . . the Bank shall provide the Deputy Comptroller with thirty (30) days prior written notice and the Deputy Comptroller shall have the authority to veto such agreements."); Connecticut Bank & Trust, Nat'l Ass'n, OCC EA No. 57, 1990 OCC Enforcement Decisions LEXIS 60, at *2 (Apr. 16, 1990) (same).

⁸⁴ Citizens Western Bank, FDIC-91-35b, FDIC Enforcement Decisions and Orders ¶ 10,238, C-1017, C-1021 (May 14, 1991) (no increases or additional compensation for directors or senior executive officers without prior written consent of FDIC Regional Director and State Bank Commissioner).

⁸⁵ See, e.g., Community Bank, FDIC-94-134b (Oct. 5, 1994), available in WESTLAW, FFIN-FDIC Database (no increases for senior executive officers or directors "in an amount exceeding one hundred five (105) percent of the annual compensation for that officer or director approved by the board of directors as of December 31, 1993 without prior written consent of the [FDIC] Regional Director"); Bank of San Francisco, FDIC-93-177b, FDIC Enforcement Decisions and Orders ¶ 10,863, C-3386, C-3391 (Aug. 19, 1993) (no increases for "any senior executive officer at a rate exceeding that officer's average rate of compensation . . . during the 12 calendar months preceding the calendar month in which the Bank became undercapitalized" without prior written approval of the FDIC); Maritime Bank, FDIC-92-339b, FDIC Enforcement Decisions and Orders ¶ 10,676, C-2866, C-2872 (Nov. 24, 1992) (no increases over 105% for senior bank officers or directors in 1993 and in subsequent years no increases over 105% without prior written approval

altogether.⁸⁶ The imposition of such limitations upon non-bank corporations is unimaginable.⁸⁷

The agencies also impose more specific limitations like requiring the bank to obtain the consent of the agency prior to making bonus payments.⁸⁸ An FDIC consent order provides some insight to the factors that the FDIC may deem important to the determination of whether to allow a bank to pay a bonus. In *In re Bank of Wallowa County*,⁸⁹ the consent order read:

of FDIC Regional Director and state bank commissioner); South Bay Bank, FDIC-92-299b, FDIC Enforcement Decisions and Orders ¶ 10,653, C-2770, C-2776 (Oct. 6, 1992) (no increases in compensation for any senior officer or director for two years and none without advance approval by the FDIC in subsequent years).

⁸⁶ Security State Bank, FDIC-90-33b, FDIC Enforcement Decisions and Orders ¶ 10,055, C-279, C-279 (Mar. 16, 1990) ("Bank shall not . . . increase in any manner whatsoever, salaries or other compensation, including, without limitation, directors' fees . . .").

⁸⁷ One area in which the federal government does intrude upon corporate compensation is in the federal procurement process. Although the regulations do not attempt to limit the amount that—or the manner in which—employees can be paid, the government limits the amount that it will compensate contractors for personal services through the Federal Acquisition Regulation. Federal Acquisition Regulation ("FAR"), 48 C.F.R. § 31.205-06 (1996). The regulation's "cost principles" instruct that compensation for personal services is "allowable" (in other words, reimbursable) only to the extent that it meets criteria and requirements set out in the regulations. *Id.* The specific cost principle addresses, among other things, the "reasonableness" of the compensation, *id.* § 31.205-06(b), bonus and incentive compensation, *id.* § 31.205-06(f), and deferred compensation, *id.* § 31.205-06(k). For a more extensive discussion of this topic, see JOHN CIBINIC, JR. & RALPH C. NASH, JR., *COST REIMBURSEMENT CONTRACTING*, 785-817 (2d ed. 1993). Another interesting analogy is discussed with regard to the congressionally-chartered institutions, Fannie Mae and Freddie Mac. See, e.g., Jennifer Corbett & John Conner, *New Agency Gears Up to Scrutinize Fannie Mae, Freddie Mac Officials' Pay*, WALL ST. J., Apr. 8, 1996, at A13.

⁸⁸ See, e.g., Bank of San Francisco, FDIC-93-177b, FDIC Enforcement Decisions and Orders ¶ 10,863, A-3386, A-3390-91 (Aug. 19, 1993) (bank shall not "pay any bonus to any senior executive officer" without prior written approval of the FDIC); Midland Bank, FDIC-93-119b (May 28, 1993) (bank shall not pay management bonuses without prior written consent of state bank commissioner and FDIC regional director), *available in* WESTLAW, FFIN-FDIC Database; First Int'l Bank, FDIC-92-82b, FDIC Enforcement Decisions and Orders ¶ 10,587, C-2506 (July 9, 1992) ("Bank shall not pay a bonus . . . to . . . any executive officer of the Bank without providing thirty (30) days written notice of such proposed action to the [FDIC] Regional Director . . ."); Bank of Westminster, FDIC-92-143b (May 20, 1992) ("Bank shall receive the prior approval of the [FDIC] Regional Director for the payment to management of bonuses of any kind and nature whatsoever . . ."), *available in* WESTLAW, FFIN-FDIC Database; Midcounty Bank & Trust Co., FDIC-90-232b, FDIC Enforcement Decisions and Orders ¶ 10,127, C-608, C-615 (Nov. 1, 1990) ("Bank shall not pay a bonus . . . to . . . any office, director, employee or related organization without providing thirty (30) days written notice of such proposed action to the [FDIC] Regional Director and the [state bank commissioner] . . ."); Norwood Co-op. Bank, FDIC-90-208b, FDIC Enforcement Decisions and Orders ¶ 10,121, C-571, C-580 (Oct. 12, 1990) (same); Security State Bank, FDIC-90-33b, FDIC Enforcement Decisions and Orders ¶ 10,055, C-279, C-279 (Mar. 16, 1990) (bank shall not pay bonuses as of effective date of consent order).

⁸⁹ Bank of Wallowa County, FDIC-90-16b, FDIC Enforcement Decisions and Orders ¶ 10,047, C-239 (Feb. 14, 1990).

The Insured Institution shall terminate its practice of paying bonuses to management, including the chief executive officer, based solely upon profits. The payment of bonuses shall be carefully justified and based on a broad range of factors, including asset quality, capital adequacy, liquidity, volume of earnings from operations rather than nonrecurring sources, and the Insured Institution's condition as assessed by the Insured Institution's regulators and reflected in the institution's most recent Report of Examination, and other appropriate factors.⁹⁰

Similar to the restrictions on bonus payments, the agencies have restricted banks' ability to enter into severance agreements without the prior consent of the agency.⁹¹ The agencies have also imposed restrictions on compensation paid to directors. For example, one order banned entirely fees paid to inside directors,⁹² one order conditioned payment of director fees on the agency's prior written consent,⁹³ another limited any increases of fees paid to directors and placed a total dollar cap on the directors' annual compensation,⁹⁴ and another

⁹⁰ *Id.* at C-244.

⁹¹ Industrial Bank, FDIC-93-233b, FDIC Enforcement Decisions and Orders ¶ 10,905, C-3516, C-3522 (Nov. 17, 1993) ("[T]he bank shall not enter into any severance agreements with any senior executive officers of the Bank . . . without the prior written consent of the [FDIC] Regional Director."); Bank of New England, OCC EA No. 77, 1990 OCC Enforcement Decisions LEXIS 58, at *5 (May 11, 1990) ("Prior to entering into any new . . . severance agreements, or renewing or extending any such existing agreements with the Bank's senior officers . . . the Bank shall provide the Deputy Comptroller with thirty (30) days prior written notice and the Deputy Comptroller shall have the authority to veto such agreements."); Connecticut Bank & Trust, OCC EA No. 57, 1990 OCC Enforcement Decisions LEXIS 60, at *2 (Apr. 16, 1990) (same).

⁹² Bank of Commerce, FDIC-93-118b, FDIC Enforcement Decisions and Orders ¶ 10,808, C-3229, C-3229-33 (May 27, 1993). The order provided that the bank would cease paying inside director fees during the life of the cease and desist order, and provided further that the bank would cease paying any "monthly community liaison fees to any director." *Id.* at C-3233; *see also* Chireno State Bank, FDIC-90-32b, FDIC Enforcement Decisions and Orders ¶ 10,059, C-297 (Mar. 30, 1990) ("[T]he Bank shall eliminate all fees paid to members of the loan committee and funds management committee for services performed on such committees.").

⁹³ Manilabank Cal., FDIC-90-240b, FDIC Enforcement Decisions and Orders ¶ 10,130, C-622, C-629 (Nov. 6, 1990) ("[T]he Bank shall not compensate any director for attending board meetings or committee meetings without the prior written approval of the [FDIC] Regional Director.").

⁹⁴ Arizona Commerce Bank, FDIC-90-100b, FDIC Enforcement Decisions and Orders ¶ 10,077, C-384, C-387 (May 30, 1990) (bank shall not pay directors for attending board or committee meetings in amount greater than that reported in last report of examination, and total compensation paid to any director shall not exceed \$75,000 during 1990); *see also* Trust Co. of N.J., FDIC-94-129b (Oct. 12, 1994) ("[A]ny compensation received by directors for attending board of director meetings and/or board committee meetings shall be explicitly set at a fixed amount per director."), available in WESTLAW, FFIN-FDIC Database; Western Community Bank, FDIC-91-90b, FDIC Enforcement Decisions and Orders ¶ 10,210, C-939, C-944 (Apr. 3, 1991)

mandated termination of the bank's directors' deferred compensation plan.⁹⁵

The most specific types of corrective measures that appear in cease and desist orders are those that address compensation paid to particular IAPs.⁹⁶ In such orders the bank may be directed to rescind all or part of its employment contract with a specific IAP,⁹⁷ or even require reimbursement for bonuses or payments previously made.⁹⁸ Some orders limit compensation paid to particular IAPs.⁹⁹

ii. Orders Shaping Future Compensation Practices

The corrective measures discussed above involve directives for some affirmative, concrete action (or forbearance from action) relating to the bank's existing compensation practices. Many cease and desist orders, however, address compensation in ways that appear in-

("[T]he Bank shall not increase or provide additional compensation to directors without the prior written consent of the [FDIC] Regional Director and the [state bank commissioner].").

⁹⁵ Green Mountain Bank, FDIC-92-48b (Feb. 14, 1992), *available in* WESTLAW, FFIN-FDIC Database; *see also* Coronado Bank, FDIC-90-106b, FDIC Enforcement Decisions and Orders ¶ 10,085, C-446, C-449 (June 19, 1990) (bank ordered to amend its records to reflect the present value of deferred compensation benefits).

⁹⁶ The IAPs may or may not be respondents in the enforcement action that gives rise to the cease and desist order.

⁹⁷ *See, e.g.*, Corporate Bank, FDIC-93-31b, FDIC Enforcement Decisions and Orders ¶ 10,958, C-3616, C-3621 (Mar. 15, 1994) ("The Bank shall rescind paragraph 6 of the Bank's Employment Agreement with Richard C. Brown dated May 15, 1990 . . ."); Golden Gate Bank, FDIC-93-50b, FDIC Enforcement Decisions and Orders ¶ 10,737, C-3101, C-3107-08 (Mar. 5, 1993) ("The Bank shall terminate and rescind the incentive-based compensation agreements which the Bank has entered into with James R. Woolwine and Joseph Torrano."); Desert Sun Bank, FDIC-90-175b, FDIC Enforcement Decisions and Orders ¶ 10,109, C-522, C-528 (Aug. 31, 1990) ("The Bank shall rescind the December 15, 1989 Consulting Agreement between the Bank and Gordon J. Cranny.");

⁹⁸ *See, e.g.*, First Nat'l Bank of Newell, OCC EA No. 573, 1991 OCC Enforcement Decisions LEXIS 343, at *2 (June 25, 1991) (bank shall initiate action to cause Roberta E. Hill to reimburse bank for bonuses, fees, or payments made to her from 1989 to 1991).

⁹⁹ Texas Coastal Bank, No. 93-048-B-SM, slip op. at 8-9 (Bd. of Governors of the Fed. Reserve Sys., May 16, 1995) (bank prohibited from paying "salary, bonus, management or service fee of any nature" to two respondents without written consent of the Federal Reserve Bank of Dallas); Robert G. Cruse, Sr., FDIC-93-191b, FDIC Enforcement Decisions and Orders ¶ 10,876, C-3428, C-3430 (Sept. 17, 1993) ("The Bank shall not pay any extraordinary compensation nor establish any severance payments for the benefit of the Individual Respondents."); William R. Bottorf, FDIC-92-120b (May 7, 1992) (except as provided, bank prohibited from paying William R. Bottorf in excess of \$39,175 and Phillip M. Lewis in excess of \$31,675), *available in* WESTLAW, FFIN-FDIC Database; First Nat'l Bank of Cold Spring, OCC EA No. 493, 1992 OCC Enforcement Decisions LEXIS 311, at *6-7 (Apr. 1, 1992) (board shall review compensation of Glenn Heitzman to ensure that total amount paid is consistent with type, level, quality and value of services Heitzman renders to bank); Columbian Nat'l Bank & Trust Co., OCC EA No. 428, 1991 OCC Enforcement Decisions LEXIS 515, at *2-3 (Nov. 25, 1991) (board shall review appropriateness of all direct and indirect compensation to, or for benefit of, Carl L. McCaffree, any of his related interests, or any of his relations by blood or marriage).

tended to affect the future course of a bank's compensation for its employees. These orders direct the bank to undertake a review of its current compensation system with a view toward improving such practices.¹⁰⁰ They mandate a review of compensation paid to all employees or, more specifically, the compensation paid to executive management or a particular IAP.

Orders directing a review of compensation typically contain a list of several factors that the bank (or board of directors) should consider in conducting their review. Among the factors to be considered in the review are: the bank's financial condition;¹⁰¹ the legitimate needs of the bank;¹⁰² the duties, responsibilities and performance of each position;¹⁰³

¹⁰⁰ See, e.g., First Nat'l Bank, OCC EA No. 679, 1992 OCC Enforcement Decisions LEXIS 120, at *17-18 (Aug. 6, 1992) (board shall develop and document program by which it determines compensation levels for all executive officers of bank to be forwarded to Director of Philadelphia Field Office for review and approval).

¹⁰¹ See, e.g., Midcounty Bank & Trust Co., FDIC-90-232b, FDIC Enforcement Decisions and Orders ¶ 10,127 at C-615 (Nov. 1, 1990) (compensation to be reviewed to determine its "appropriateness in view of the Bank's current and projected levels of earnings"); Norwood Co-op. Bank, FDIC-90-208b, FDIC Enforcement Decisions and Orders ¶ 10,121 at C-580 (Oct. 12, 1990) (same); see also Written Agreement by and among Execufirst Bancorp, Inc., First Executive Bank and Fed. Reserve Bank of Philadelphia, No. 95-010-WA/RB-HC, slip op. at 5 (Bd. of Governors of the Fed. Reserve Sys., May 24, 1995) (compensation to be "justified based on the Bank's financial condition, including, but not limited to, the Bank's earnings, asset quality, liquidity, and capital needs").

¹⁰² See, e.g., Columbian Nat'l Bank & Trust Co., OCC EA No. 428, 1991 OCC Enforcement Decisions LEXIS 515, at *3 (Nov. 25, 1991) (written insider compensation plan "shall require that each payment be made only for legitimate bank business needs"); Security Bank, OCC EA No. 340, 1991 OCC Enforcement Decisions LEXIS 129, at *9 (Aug. 12, 1991) (same); First Nat'l Bank, OCC EA No. 573, 1991 OCC Enforcement Decisions LEXIS 343, at *3 (June 25, 1991) (same); see also Written Agreement by and among Execufirst Bancorp, Inc., First Executive Bank and Fed. Reserve Bank of Philadelphia, No. 95-010-WA/RB-HC, slip op. at 5 (Bd. of Governors of the Fed. Reserve Sys., May 24, 1995) (compensation to be "related to the services actually rendered to or on behalf of the Bank").

¹⁰³ See, e.g., First Los Angeles Bank, FDIC-94-130b (Oct. 3, 1994) (compensation review to include "a critical analysis of each individual's background, experience, duties and responsibilities, and an appraisal of each individual's performance compared to the present level of compensation"), available in WESTLAW, FFIN-FDIC Database; Wilshire State Bank, FDIC-93-101b, FDIC Enforcement Decisions and Orders ¶ 10,799, C-3208, C-3214 (May 14, 1993) (same); First Fidelity Thrift & Loan, FDIC-93-41b, FDIC Enforcement Decisions and Orders ¶ 10,731, C-3062, C-3069 (Feb. 26, 1993) (same); First State Bank, FDIC-92-243b, FDIC Enforcement Decisions and Orders ¶ 10,608, C-2600, C-2606 (July 30, 1992) (compensation report to include "a statement of the duties and responsibilities of, and the actual services performed for the Bank by, each director, officer and employee"); Citizens W. Bank, FDIC-91-35b, FDIC Enforcement Decisions and Orders ¶ 10,238, C-1017, C-1021 (May 14, 1991) (compensation review to include "a critical analysis of each individual's duties and responsibilities, and an appraisal of each individual's performance compared to the present level of compensation"); see also Written Agreement by and among Execufirst Bancorp, Inc., First Executive Bank and Fed. Reserve Bank of Philadelphia, No. 95-010-WA/RB-HC, slip op. at 5 (Bd. of Governors of the Fed. Reserve Sys., May 24, 1995) (compensation to be "paid in accordance with the duties, responsibilities and obligations of the Bank's executive officers and directors"); Charter Pacific Bank, FDIC-92-253b,

and the compensation paid by financial institutions of comparable size, condition and geographic location.¹⁰⁴

Some orders contain requirements aimed at obtaining an objective, unbiased review of the bank's compensation practices. For example, some orders call for the assistance of an outside consultant in the development of a compensation plan.¹⁰⁵ A few orders mandate that the review be conducted by an independent board committee.¹⁰⁶

FDIC Enforcement Decisions and Orders ¶ 10,895, C-3485, C-3490 (Nov. 2, 1993) (written executive compensation agreement to "incorporate qualitative as well as profitability performance standards"); Brentwood Thrift & Loan Ass'n, FDIC-93-220b, FDIC Enforcement Decisions and Orders ¶ 10,878, C-3432, C-3445 (Sept. 21, 1993) (same); Seoul Bank of Cal., FDIC-93-57b, FDIC Enforcement Decisions and Orders ¶ 10,762, C-3145, C-3151 (Mar. 19, 1993) (same).

¹⁰⁴ See, e.g., First Los Angeles Bank, FDIC-94-130b (Oct. 3, 1994) (compensation review to include "a comparison of each officer's total compensation with compensation received by officers with similar responsibilities in similar institutions"), available in WESTLAW, FFIN-FDIC Database; Wilshire State Bank, FDIC-93-101b, FDIC Enforcement Decisions and Orders ¶ 10,799, C-3208, C-3214 (May 14, 1993) (same); First Fidelity Thrift & Loan, FDIC-93-41b, FDIC Enforcement Decisions and Orders ¶ 10,731, at C-3069 (Feb. 26, 1993) (same); First State Bank, FDIC-92-243b, FDIC Enforcement Decisions and Orders ¶ 10,608, C-2600, C-2606 (July 30, 1992) (compensation report to take into consideration "any industry standards for banks of comparable size offering similar services"); First Cal. Bank, FDIC-91-204b (July 18, 1991) (compensation review to include "a comparison of each officer's total compensation with compensation received by officers with similar responsibilities in similar institutions"), available in WESTLAW, FFIN-FDIC Database; American State Bank, FDIC-90-43b (Mar. 23, 1990) (compensation in new budget plan "should be comparable to fees paid in other financial institutions of similar size and characteristics"), available in WESTLAW, FFIN-FDIC Database; see also Written Agreement by and among Execufirst Bancorp, Inc., First Executive Bank and Fed. Reserve Bank of Philadelphia, No. 95-010-WA/RB-HC, slip op. at 5 (Bd. of Governors of the Fed. Reserve Sys., May 24, 1995) (compensation to be consistent with salaries and bonuses paid by financial institutions of comparable size, condition and geographic location).

¹⁰⁵ See, e.g., Bank of Walnut, FDIC-91-369b, FDIC Enforcement Decisions and Orders ¶ 10,647, C-2729, C-2736 (Sept. 29, 1992) (bank ordered to hire independent external auditor, acceptable to FDIC, to determine reasonableness of compensation paid to three IAPs and their related interests); Gladstone-Norwood Trust & Sav. Bank, FDIC-92-279b (Sept. 9, 1992) (bank ordered to hire bank consultant acceptable to FDIC to "develop a written analysis and assessment of the Bank's senior executive officers, management and staffing needs of Bank's loan department"), available in WESTLAW, FFIN-FDIC Database; Marathon Nat'l Bank, OCC EA No. 670, 1992 OCC Enforcement Decisions LEXIS 111, at *2 (Aug. 10, 1992) (consultant to assess reasonableness of method used to determine management and board compensation, including bonuses); Vinings Bank & Trust, Nat'l Ass'n, OCC EA No. 435, 1992 OCC Enforcement Decisions LEXIS 19, at *3-4 (Jan. 8, 1992) (consultant shall evaluate performance of each officer of bank with conclusion reached as to the adequacy of performance and appropriateness of each officer's compensation); Continental Nat'l Bank, OCC EA No. 440, 1992 OCC Enforcement Decisions LEXIS 16, at *2-4 (Jan. 22, 1992) (bank ordered to employ "an independent outside management consultant," subject to OCC's approval, to evaluate bank's compensation and bonus plans); Metro Bank, N.A., OCC EA No. 198, 1991 OCC Enforcement Decisions LEXIS 15, at *5 (Apr. 1, 1991) (formal agreement) (bank ordered to complete study of compensation and benefits paid to executive management and may use outside management consultant to complete study); Paul C. Hufnagle, FDIC-90-104b (Jan. 4, 1991) (bank ordered to hire "an individual or firm that is independent with respect to the Bank and that possesses recognized expertise in banking" to perform an audit of payments made to IAPs), available in WESTLAW, FFIN-FDIC Database.

¹⁰⁶ See, e.g., City Nat'l Bank, OCC EA No. 438, 1992 OCC Enforcement Decisions LEXIS 17,

B. Agency Regulations

In addition to their broad authority to bring formal enforcement actions for unsafe or unsound banking practices, the agencies have promulgated various regulations¹⁰⁷ specifically limiting compensation practices.¹⁰⁸ The regulations discussed in this section are those that are applicable to banks regardless of their financial condition.¹⁰⁹ Regulations that target financially troubled banks are discussed in part II.

1. Employment Contracts

In 1982, the OTS adopted regulations limiting savings associations' ability to enter into employment contracts.¹¹⁰ Section 563.39 provides that a savings association may enter into an employment contract with its officers or other employees but that any such contract must be in accordance with the section's provisions.¹¹¹ The purpose of this regulation was to "terminate contracts negotiated by the failed institution in the past, which 'bestow[ed] huge benefits on the very managers who were responsible for the bank's demise.'"¹¹² As will be clear from the discussion below, however, the regulation goes far beyond its stated purpose. The regulation's provisions operate to termi-

at *1-3 (Jan. 21, 1992) (bank ordered to appoint compliance committee to review and report on appropriateness of director and management compensation and other issues); Continental Nat'l Bank, OCC EA No. 440, 1992 OCC Enforcement Decisions LEXIS 16, at *2-4 (Jan. 22, 1992) (bank ordered to appoint compliance committee to address compensation and other issues, comprised of at least five directors who were not bank officers, subject to OCC veto); Worthington State Bank, FDIC-91-191b (July 9, 1991) (bank ordered to establish a salary review committee comprised of independent directors), *available in* WESTLAW, FFIN-FDIC Database.

¹⁰⁷ The discussion herein focuses on agency regulations with the most comprehensive impact upon compensation. For more specific limitations, see 60 Fed. Reg. 47498 (1995) (proposed Sept. 13, 1995) (OCC's proposed rule regarding limitations on compensation for credit life insurance sales).

¹⁰⁸ The Securities and Exchange Commission has promulgated regulations covering disclosure of compensation paid to certain corporate executives. *See supra* note 14. This article focuses on regulations that are peculiar to banks. The SEC's disclosure regulations are beyond the scope of this article since they are applicable to both bank and nonbank corporations. The FDIC promulgated disclosure rules substantially similar to the SEC requirements. 12 C.F.R. § 335 (1996).

¹⁰⁹ As a practical matter, however, the regulations most often become an issue in administrative actions or in litigation when the bank is troubled or failed.

¹¹⁰ 12 C.F.R. § 563.39. This is an OTS regulation only. Therefore, it has no application to commercial banks.

¹¹¹ *Id.* § 563.39(a).

¹¹² *Rice v. Resolution Trust Corp.*, 785 F. Supp. 1385, 1388 (D. Ariz. 1992) (citing *Federal Sav. & Loan Ins. Corp. v. Quinn*, 922 F.2d 1251, 1257 (6th Cir. 1991)). *See also* *Texas Commerce Bank, N.A. v. United Sav. Ass'n*, 789 F. Supp. 848, 851-52 (S.D. Tex. 1992) (citing 47 Fed. Reg. 17471 (1982)) (The underlying purpose "was to provide the [Federal Savings and Loan Insurance Corporation, the OTS's predecessor] with greater flexibility to reject excessive terms and excessive benefit contracts for employment").

nate employment agreements under certain circumstances, without any finding of lack of care or negligence on the part of the employees receiving benefits under such contracts.

Section 563.39 provides that the employment contract must be in writing,¹¹³ and may not constitute an unsafe or unsound banking practice.¹¹⁴ The regulation provides that the contract must contain the following five provisions relating to termination.¹¹⁵ First, the savings association may terminate an employee's employment at any time.¹¹⁶ This provision does not affect the employee's rights to compensation under the contract.¹¹⁷ Second, if the employee is suspended or temporarily removed from office,¹¹⁸ then the savings association's obligations under the contract are suspended.¹¹⁹ Third, the savings association's obligations under the contract terminate in the event the employee is permanently removed from office.¹²⁰ Vested rights under the contract, however, are not affected by this provision.¹²¹ Fourth, unless the Director of the OTS grants prior written approval, the obligations under the contract terminate in the event the savings association is placed in a receivership or conservatorship.¹²² Again, vested rights are not affected

¹¹³ 12 C.F.R. § 563.39(a).

¹¹⁴ *Id.* With regard to what would constitute an unsafe or unsound banking practice in this context, the regulation explains:

The making of such an employment contract would be an unsafe or unsound practice if such contract could lead to material financial loss or damage to the association or could interfere materially with the exercise by the members of its board of directors of their duty or discretion provided by law, charter, bylaw or regulation as to the employment or termination of employment of an officer or employee of the association. This may occur, depending upon the circumstances of the case, where an employment contract provides for an excessive term.

Id.

¹¹⁵ *Id.* § 563.39(b). Even if these provisions are not included in the actual employment contract, they will be considered implied terms of the agreement. *Barnes v. Resolution Trust Corp.*, No. 91-2011-V, 1992 U.S. Dist. LEXIS 1841, at *8 (D. Kan. 1992).

¹¹⁶ 12 C.F.R. § 563.39(b)(1).

¹¹⁷ *Id.* The employee, however, will not have rights to compensation or benefits "for any period after termination for cause." *Id.* This provision further provides that termination for cause shall include termination because of the officer or employee's personal dishonesty, incompetence, willful misconduct, breach of fiduciary duty involving personal profit, intentional failure to perform stated duties, willful violation of any law, rule, or regulation (other than traffic violations or similar offenses) or final cease-and-desist order, or material breach of any provision of the contract.

Id.

¹¹⁸ See *supra* notes 30-43 and accompanying text (discussing the agencies' authority to remove IAPs from office).

¹¹⁹ 12 C.F.R. § 563.39(b)(2).

¹²⁰ *Id.* § 563.39(b)(3).

¹²¹ *Id.* For a discussion of courts' interpretation of "vested rights" under this regulation, see *supra* notes 131-43 and accompanying text.

¹²² 12 C.F.R. § 563.39(b)(4); 12 U.S.C. § 1813(x) (1996).

by this provision.¹²³ Fifth, the OTS Director may terminate all obligations under the contract if the FDIC or RTC agrees to provide assistance to the savings association, if a supervisory merger of the association is approved, or if the Director determines that the savings association is in an unsafe or unsound condition.¹²⁴ None of the five termination provisions requires any finding of wrongdoing on the part of the employee.

The litigation involving Section 563.39 has focused upon issues of interpretation. As discussed below, courts have considered the meaning of the terms "employment contract" and "vested rights" in the context of this regulation.

a. *Interpretation of "Employment Contract"*

Courts have examined at length the meaning of the term "employment contract."¹²⁵ This is an important issue in any case involving Section 563.39 since the regulation only limits a savings association's ability to enter into employment contracts, and not every contract between an employee and a savings association is an employment contract subject to the restrictions of this regulation. Courts have resorted to a dictionary definition which defines an employment contract as "an agreement or contract between employer and employee in which the terms and conditions of one's employment are provided."¹²⁶ Relying upon this definition,¹²⁷ courts have looked to whether the contract in question contains terms and conditions of employment, such as a covenant not to compete¹²⁸ or an agreement to maintain no other employment.¹²⁹ If the contract does not contain terms of employment, it is not an employment contract governed by the regulation.¹³⁰

b. *Interpretation of "Vested Rights"*

The second major issue of interpretation of Section 563.39 involves the meaning of the term "vested rights." While the regulation

¹²³ 12 C.F.R. § 563.39(b)(4); 12 U.S.C. § 1813(x).

¹²⁴ 12 C.F.R. § 563.39(b)(5).

¹²⁵ Section 563.39 provides no definition for "employment contract."

¹²⁶ *Rice v. Resolution Trust Corp.*, 785 F. Supp. 1385, 1388 (D. Ariz. 1992) (quoting BLACK'S LAW DICTIONARY 363 (6th ed. 1990)).

¹²⁷ The following decisions have relied on the BLACK'S LAW DICTIONARY definition: *Modzelewski v. Resolution Trust Corp.*, 14 F.3d 1374, 1376 (9th Cir. 1994); *Majeski v. Resolution Trust Corp.*, No. Civ. A. 94-738, 1995 WL 115953, at *3 (D.D.C. Feb. 8, 1995); *Marsa v. Metrobank for Sav.*, F.S.B., 825 F. Supp. 658, 663 (D.N.J. 1993); *Rice*, 785 F. Supp. at 1390.

¹²⁸ *Modzelewski*, 14 F.3d at 1376; *Rice*, 785 F. Supp. at 1389.

¹²⁹ *Modzelewski*, 14 F.3d at 1376; *Rice*, 785 F. Supp. at 1389.

¹³⁰ *Majeski*, No. Civ. A. 94-738, 1995 WL 115953, at *3; *Marsa*, 825 F. Supp. at 663; *Fresca v. FDIC*, 818 F. Supp. 664, 667 (S.D.N.Y. 1993).

requires employment contracts to include provisions allowing for the termination of a savings association's obligations under the contract under certain circumstances, two of the termination provisions carry the caveat that vested rights are not affected by such termination. One of the provisions that preserves vested rights allows for the termination of the savings association's obligations in the event the employee is permanently removed from office.¹³¹ The other provision that preserves vested rights allows for the termination of the savings association's obligations under the contract if the savings association receives assistance from the FDIC or RTC or is found to be in an unsafe or unsound condition.¹³² As illustrated below, the latter provision has become very important in cases in which the FDIC or RTC have been appointed as receiver for a failed institution.¹³³ In such cases, the FDIC and RTC have used the provision to avoid payments under employment contracts, arguing that the obligations under the contracts terminate upon their appointment as receiver. The issue of vesting in many such cases is dispositive.

The term "vested rights" is not defined in Section 563.39. In supplying a workable definition, the United States Court of Appeals for the Ninth Circuit concluded:

[I]n order to be vested as that term is used in [Section 563.39], rights need not be free of every contingency or possibility of divestiture. Rather, a right is vested when the employee holding the right is entitled to claim immediate payment. It's not material that the employee fails to make such a demand—exposing himself to the risk of divestiture—so long as the decision not to claim payment lies entirely within his control.¹³⁴

The Ninth Circuit applied this definition in a case involving the RTC's refusal to pay two executives of MeraBank under a "salary continuation agreement."¹³⁵ The agreement provided the executives, Ernest Modzelewski and Gene Rice, with 120 monthly payments in the event of retirement, death or termination. The purpose of the agreement was "presumably to secure the most talented managers."¹³⁶

¹³¹ See *supra* note 120 and accompanying text.

¹³² See *supra* note 124 and accompanying text.

¹³³ Obviously, there were a great many of such cases in the wake of the savings and loan crisis.

¹³⁴ *Modzelewski*, 14 F.3d at 1378.

¹³⁵ *Id.*

¹³⁶ *Id.* at 1375. The RTC proved no wrongdoing by the executives. The court chastised the RTC on this score: "RTC also insinuates throughout its briefs that Rice and Modzelewski led

MeraBank failed in January of 1990, and the RTC took over as receiver. The RTC refused to pay Modzelewski and Rice under the salary continuation agreement claiming, among other things, that the agreement terminated under Section 563.39(b)(5) upon appointment of the RTC as receiver¹³⁷ and that the employees' rights had not vested at the time of termination. The court concluded that, because Rice reached retirement age prior to the RTC's appointment as receiver, his rights under the agreement had vested.¹³⁸ The court, however, concluded that Modzelewski's rights had not vested under the agreement.¹³⁹ The court reasoned that because Modzelewski had not reached retirement age at the time of termination of the agreement and, therefore, had not yet, as of the time of termination, earned the right to claim benefits under the agreement, his rights had not vested.¹⁴⁰

District courts have applied a similar line of reasoning in addressing the question of whether rights under an employment contract have vested.¹⁴¹ If all conditions under the employment agreement are met prior to termination of the agreement under the provisions of Section 563.39 (most frequently upon the appointment of the FDIC or RTC as receiver), then the employee's rights will be deemed vested.¹⁴² On the other hand, if a condition under the employment agreement is not met at the time of termination under Section 563.39, rights under the agreement are not vested and are therefore forfeited. For example, rights under a severance agreement that provides employees with benefits in the event the employee is terminated without cause would be for-

MeraBank to its ruin and should therefore be denied their benefits. Obviously, many circumstances contributed to the S & L crisis, and we consider it inappropriate for counsel to cast aspersions without any support in the record." *Id.* at 1376 n.1.

¹³⁷ Section 563.39(b)(5) provides, in pertinent part, for termination of the obligations under the employment contract in the event the savings association receives assistance from the RTC. See *supra* note 124 and accompanying text.

¹³⁸ *Modzelewski*, 14 F.3d at 1378.

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 1378. The Ninth Circuit adopted the same reasoning in a subsequent, similar case in which the plaintiff had not reached retirement age prior to the termination of an alleged agreement to pay retirement benefits beginning at age 65. See *Aronson v. Resolution Trust Corp.*, 38 F.3d 1110, 1113 (9th Cir. 1994). The court held that the plaintiff's rights had not vested. *Id.*

¹⁴¹ Although many of these cases apply similar reasoning, they do not necessarily follow the Ninth Circuit's *Modzelewski* decision since many of the district court cases pre-date that decision.

¹⁴² See, e.g., *Fresca*, 818 F. Supp. at 666 (plaintiff's rights to benefits under early retirement package vested when she retired almost one year prior to appointment of FDIC as receiver); *Marsa*, 825 F. Supp. at 664 (plaintiff's rights under settlement agreement vested when he executed the agreement and resigned his position which occurred over a year prior to appointment of RTC as receiver); *Texas Commerce Bank, N.A. v. United Sav. Ass'n*, 789 F. Supp. 848, 852 (S.D. Tex. 1992) (employees' rights under compensation plan vested when employees continued to work through date designated in plan which was same date of appointment of FSLIC as receiver).

feited if that condition was not met at the time the bank was placed in receivership.¹⁴³

2. Safety and Soundness Standards

As discussed above, the concept of "safety and soundness" underlies the most comprehensive powers enjoyed by the federal banking agencies. Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") with the goal of providing the banking agencies with new powers designed to prevent problems in banks' operations or, at a minimum, to resolve problems at the least cost to the deposit insurance fund.¹⁴⁴ Included in these new powers is a new Section 39 of the FDIA directing each federal banking agency to prescribe standards for safety and soundness¹⁴⁵ in several important areas of bank operations, including compensation practices.¹⁴⁶ These safety and soundness standards are applicable to a bank regardless of the bank's financial condition.

Section 39 of the FDIA includes two provisions affecting banks' compensation practices. First, Section 39(a) directs the agencies to prescribe, by guideline or regulation, standards relating to "compensation, fees, and benefits."¹⁴⁷ Second, Section 39(c) directs the agencies to prohibit, by guideline or regulation, practices that would provide "excessive compensation, fees, or benefits" or that could "lead to material financial loss" to the bank.¹⁴⁸ Moreover, Congress directed that

¹⁴³ See, e.g., *Romines v. Great-West Life Assurance Co.*, 865 F. Supp. 607, 610 (E.D. Mo. 1994) (plaintiff's rights to payments were conditioned on termination without cause; this condition did not occur prior to termination of employment agreement under provisions of § 563.39); *Rice v. Resolution Trust Corp.*, 785 F. Supp. 1385, 1392 (D. Ariz. 1992) (same); *Barnes v. Resolution Trust Corp.*, No. 91-2011-V, 1992 U.S. Dist. LEXIS 1841, at 7 (D. Kan. 1992) (same).

¹⁴⁴ 12 U.S.C. § 1831o(a) (1996).

¹⁴⁵ *Id.* § 1831p-1. Since the enactment of FDICIA, § 39 of the FDIA has been amended twice. First by § 956 of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, and second by § 318 of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325. FDICIA also granted the agencies the authority to take various forms of action once an institution fails to meet defined capital standards. See *infra* part II.A (discussing prompt corrective action provisions of FDICIA relating to troubled institutions).

¹⁴⁶ 12 U.S.C. § 1831p-1(a)(1)(F). The other operational and management standards required by § 39 include standards relating to banks' internal controls, loan documentation, credit underwriting, interest rate exposure and asset growth. *Id.* § 1831p-1(a)(1)(A)-(E). Section 39 also requires the agencies to prescribe standards relating to asset quality, earnings and stock valuation. *Id.* § 1831p-1(b).

¹⁴⁷ *Id.* § 1831p-1(a)(1)(F). These standards must be "in accordance with [Section 39(c)]." *Id.* Section 39(c) is discussed *infra* note 148.

¹⁴⁸ 12 U.S.C. § 1831p-1(c). Section 39(c) of the FDIA provides:

Compensation standards. Each appropriate Federal banking agency shall, for all insured depository institutions, prescribe—

any guideline or regulation promulgated under Section 39 "may not prescribe standards that set a specific level or range of compensation for directors, officers or employees of insured depository institutions."¹⁴⁹

If a bank fails to meet the standards prescribed under Section 39(a), the bank must submit a plan, acceptable to the agency, specifying the steps the institution will take to correct the deficiency.¹⁵⁰ If the institution fails to submit an acceptable plan, or fails to implement a plan accepted by the agency, the agency has broad authority to mandate remedial measures. Under such circumstances, Congress granted the agencies the authority to take any of the following supervisory actions until the deficiency is corrected: (i) prohibit growth of the bank's average total assets;¹⁵¹ (ii) require the bank to increase its ratio

(1) standards prohibiting as an unsafe and unsound practice any employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement that—

(A) would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or

(B) could lead to material financial loss to the institution;

(2) standards specifying when compensation, fees, or benefits referred to in paragraph (1) are excessive, which shall require the agency to determine whether the amounts are unreasonable or disproportionate to the services actually performed by the individual by considering—

(A) the combined value of all cash and noncash benefits provided to the individual;

(B) the compensation history of the individual and other individuals with comparable expertise at the institution;

(C) the financial condition of the institution;

(D) comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;

(E) for postemployment benefits, the projected total cost and benefit to the institution;

(F) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and

(G) other factors that the agency determines to be relevant; and

(3) such other standards relating to compensation, fees, and benefits as the agency determines to be appropriate.

Id.

¹⁴⁹ *Id.* § 1831p-1(d)(1). This provision, however, does not affect the agencies' authority to restrict the level of compensation paid to bank personnel under any other provision of law. *Id.* § 1831p-1(d)(2).

¹⁵⁰ *Id.* § 1831p-1(e)(1).

¹⁵¹ Specifically, the AFBA may:

[p]rohibit the [bank] from permitting its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar quarter, or restrict the rate at which the average total assets of the [bank] may increase from one calendar quarter to another.

Id. § 1831p-1(e)(2)(B)(i).

of tangible equity to assets;¹⁵² (iii) restrict the interest rates the bank pays on deposits;¹⁵³ and (iv) require the institution to take any other action that will serve the purpose of resolving the bank's problems with the least possible long-term loss to the deposit insurance fund.¹⁵⁴

Section 39 provides no specific consequences in the event a bank engages in practices proscribed by Section 39(c). Presumably, such practices would constitute unsafe or unsound banking practices allowing the agencies to utilize their formal enforcement powers.¹⁵⁵ In addition, the agencies retain the authority to initiate enforcement proceedings without the necessity of proving a violation of the Section 39 guidelines or regulations. Section 39 does not restrict the agencies' ability to bring such actions.¹⁵⁶

In July of 1992, the federal banking agencies published a Joint Advance Notice of Proposed Rulemaking ("ANPR") requesting comments on the issues raised by Section 39.¹⁵⁷ The agencies received over 400 comments and published a Notice of Proposed Rulemaking ("NPR") in November of 1993.¹⁵⁸ The NPR reported that commenters strongly preferred general, rather than specific, standards "to avoid regulatory micromanagement of the banking and thrift industries."¹⁵⁹

Two-and-a-half years later, in July of 1995, the agencies issued a final rule promulgating Interagency Guidelines Establishing Standards for Safety and Soundness ("Guidelines").¹⁶⁰ In creating standards relating to compensation,¹⁶¹ the Guidelines embrace the preference of commentators for general, as opposed to specific, standards. The Guide-

¹⁵² *Id.* § 1831p-1(e)(2)(B)(ii).

¹⁵³ Section 1831p-1(e)(2)(B)(iii) allows the AFBA to take any action described in Section 1831o(f)(2)(C). The latter allows the AFBA to "[r]estrict[] the interest rates that the [bank] pays on deposits to the prevailing rates of interest on deposits of comparable amounts and maturities in the region where the institution is located, as determined by the agency." 12 U.S.C. § 1831o(f)(2)(C)(i).

¹⁵⁴ *See id.* § 1831p-1(e)(2)(B)(iv); *id.* § 1831o(a)(1).

¹⁵⁵ *See supra* part I.A (discussing the agencies' formal enforcement powers).

¹⁵⁶ 12 U.S.C. § 1831p-1(d)(4)(B); *id.* § 1831p-1(g).

¹⁵⁷ 57 Fed. Reg. 31336 (1992).

¹⁵⁸ 58 Fed. Reg. 60802 (1993). For an analysis of the NPR, see generally Baxter, *supra* note 25.

¹⁵⁹ 58 Fed. Reg. 60802, 60803 (1993). The majority of the comments came from banks. *Id.*

¹⁶⁰ 60 Fed. Reg. 35674 (1995). Section 39 permits the agencies to adopt standards for safety and soundness by either regulation or guideline. *See supra* note 147 and accompanying text.

¹⁶¹ The Guidelines define "compensation" as follows:

[A]ll direct and indirect payments or benefits, both cash and non-cash, granted to or for the benefit of any executive officer, employee, director, or principal shareholder, including but not limited to payments or benefits derived from an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

60 Fed. Reg. at 35679.

lines issued under Section 39(a) require only that "[a]n institution should maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or that could lead to material financial loss to the institution."¹⁶² In providing standards for what would constitute "excessive" compensation prohibited under Section 39(c),¹⁶³ the Guidelines rely solely on the language of the statute.¹⁶⁴ The last of the seven factors provided in Section 39(c) is "other factors that the agency determines to be relevant."¹⁶⁵ Since the Guidelines adopt the statutory factors almost verbatim, the agencies have provided no guidance on what other "factors" might be relevant in determining what constitutes "excessive" compensation. Finally, in providing standards for what would constitute compensation that "could lead to material financial loss to the institution," also prohibited under Section 39(c),¹⁶⁶ the Guidelines state only that "[c]ompensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice."¹⁶⁷

II. TROUBLED INSTITUTIONS

The bank agencies' interest in a bank's day to day business affairs is heightened when that bank begins to experience financial trouble. The experience of the savings and loan crisis of the 1980s led Congress to the conclusion that the agencies must be given the tools and the mandate to fix what is broken in an institution before it is beyond repair. In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"),¹⁶⁸ which includes provisions for "prompt corrective action" mandating the agencies to assume a more proactive role with regard to the supervision of troubled institutions.¹⁶⁹ This part of the article will discuss FDICIA's prompt corrective action provision, including its limitations on banks' compensation practices.

Congress also sought to prevent the management abuses that are believed to be part of the cause of the savings and loan crisis.¹⁷⁰ Stories

¹⁶² *Id.* at 35680.

¹⁶³ *See supra* note 148 and accompanying text.

¹⁶⁴ 60 Fed. Reg. at 35680. *See supra* text accompanying note 114 (proposing language of the statute).

¹⁶⁵ 12 U.S.C. § 1831p-1(c)(2)(G).

¹⁶⁶ *Id.* § 1831p-1(c)(1)(B).

¹⁶⁷ 60 Fed. Reg. at 35680.

¹⁶⁸ Pub. L. No. 12-242, 105 Stat. 2236 (codified in scattered sections of 12 U.S.C.).

¹⁶⁹ *See generally* Lawrence G. Baxter, *Administrative and Judicial Review of Prompt Corrective Action Decisions by the Federal Banking Regulators*, 7 ADMIN. L.J. 505 (1993).

¹⁷⁰ *See id.*

of executives who raided bank coffers when the bank was on the brink of failure were likely the source of Congress's resolve to pass legislation prohibiting certain "golden parachute payments." This legislation is also analyzed in this part.

A. Prompt Corrective Action: Limitations on Executive Compensation for Undercapitalized Institutions

In enacting FDICIA, Congress created a scheme of "prompt corrective action," the purpose of which was "to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund."¹⁷¹ The prompt corrective action provisions operate on what has been described as a "tripwire" system,¹⁷² which allows the agencies to take various forms of action once a bank fails to meet certain capital requirements. The prompt corrective action provisions delineate five capital categories:¹⁷³ well capitalized,¹⁷⁴ adequately capitalized,¹⁷⁵ undercapitalized,¹⁷⁶ significantly undercapitalized¹⁷⁷ or critically undercapitalized.¹⁷⁸ A bank's failure to meet the requirements of a well capitalized or adequately capitalized institution has various, and at times draconian, supervisory ramifications. For example, an undercapitalized institution must submit an acceptable capital restoration plan to the AFBA, and the AFBA is required to closely monitor the institution and its compliance with any capital

¹⁷¹ 12 U.S.C. § 1831o(a)(1). The prompt corrective action scheme is based on the premise that the longer an insolvent bank is allowed to remain open, the more costly it will be to ultimately resolve the bank once it fails. H.R. REP. NO. 102-330, at 103-104 (1991), *reprinted in* 1991 U.S.C.C.A.N. 1901, 1916-17. *See generally* Baxter, *supra* note 169, at 505.

¹⁷² Baxter, *supra* note 169, at 516-28.

¹⁷³ 12 U.S.C. § 1831o(b)(1)(A)-(E).

¹⁷⁴ "Well capitalized" is defined in the regulations of each AFBA. *See* 12 C.F.R. § 325.103(b)(1) (FDIC regulations); *id.* § 208.33(b)(1) (Fed regulations); *id.* § 6.4(b)(1) (OCC regulations); *id.* § 565.4(b)(1) (OTS regulations).

¹⁷⁵ "Adequately capitalized" is defined in the regulations of each AFBA. *See id.* § 325.103(b)(2) (FDIC regulations); *id.* § 208.33(b)(2) (Fed regulations); *id.* § 6.4(b)(2) (OCC regulations); *id.* § 565.4(b)(2) (OTS regulations).

¹⁷⁶ "Undercapitalized" is defined in the regulations of each AFBA. *See id.* § 325.103(b)(3) (FDIC regulations); *id.* § 208.33(b)(3) (Fed. regulations); *id.* § 6.4(b)(3) (OCC regulations); *id.* § 565.4(b)(3) (OTS regulations).

¹⁷⁷ "Significantly undercapitalized" is defined in the regulations of each AFBA. *See id.* § 325.103(b)(4) (FDIC regulations); *id.* § 208.33(b)(4) (Fed. regulations); *id.* § 6.4(b)(4) (OCC regulations); *id.* § 565.4(b)(4) (OTS regulations).

¹⁷⁸ "Critically undercapitalized" is defined in the regulations of each AFBA. *See id.* § 325.103(b)(5) (FDIC regulations); *id.* § 208.33(b)(5) (Fed. regulations); *id.* § 6.4(b)(5) (OCC regulations); *id.* § 565.4(b)(5) (OTS regulations). For a discussion of the application of this standard, see *Life Bancshares, Inc., v. Fichter*, 847 F. Supp. 434, 438-39 (M.D. La. 1993) (officer, director and shareholder challenge to OTS's appointment of receiver).

restoration plan.¹⁷⁹ No later than ninety days after an institution becomes critically undercapitalized, the AFBA must appoint a receiver for the institution or document the reasons that an alternative course of action would involve the least long-term loss to the deposit insurance fund.¹⁸⁰

The prompt corrective actions provisions also impact a bank's executive compensation. Banks that are significantly undercapitalized or that are undercapitalized and have failed to submit or implement an acceptable capital restoration plan may not, without prior written approval of the AFBA, pay any bonus to any senior executive officer or provide compensation to any senior executive office that exceeds the officer's average compensation during the twelve months preceding the month during which the bank became undercapitalized.¹⁸¹

B. *Golden Parachute Payments*

The Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 ("Fraud Act")¹⁸² amended the FDIA to provide the FDIC with the ability to prohibit or limit certain payments payable to IAPs upon terminating their affiliation with their respective banks. Specifically, Section 1828(k)(1) provides that the FDIC "may prohibit or limit, by regulation or order, any golden parachute payment"¹⁸³

The statutory definition of "golden parachute payment" has three components. First, there must be a "payment" which includes "any payment (or any agreement to make any payment) in the nature of compensation by any [bank or bank holding company] for the benefit of any [IAP]"¹⁸⁴ Second, the obligation of the bank or bank holding company to make the payment to the IAP must be contingent on the termination of the IAP's affiliation with the bank or bank holding company.¹⁸⁵ Finally, the payment must be received on or after a date on which one of the following events has occurred: (i) the bank, the bank holding company or any bank subsidiary of the bank holding

¹⁷⁹ 12 U.S.C. § 1831o(e).

¹⁸⁰ *Id.* § 1831o(h)(3).

¹⁸¹ *Id.* § 1831o(f)(4)(A). The AFBA is prohibited from granting such approval for an officer of any institution that has failed to submit an acceptable capital restoration plan. *Id.* § 1831o(f)(4)(B).

¹⁸² Pub. L. No. 101-647, § 2523 (1990).

¹⁸³ 12 U.S.C. § 1828(k) (1996). Section 1828(k) also permits the FDIC to prohibit or limit any indemnification payment. *Id.* The issue of indemnification is beyond the scope of this article.

¹⁸⁴ *Id.* § 1828(k)(4)(A).

¹⁸⁵ *Id.* § 1828(k)(4)(A)(i).

company becomes insolvent; (ii) a conservator or receiver is appointed for the bank or the bank holding company; (iii) the AFBA determines that the bank is in a troubled condition; (iv) the bank has received a rating of four or five under the Uniform Financial Institutions Rating System; or (v) the FDIC has initiated a proceeding against the bank to terminate or suspend its deposit insurance.¹⁸⁶ Under the statute, the term "golden parachute payments" do not include the following: payments under certain retirement plans,¹⁸⁷ payments made pursuant to a bona fide deferred compensation plan that the FDIC determines to be permissible¹⁸⁸ and payments made by reason of death or disability.¹⁸⁹

On October 7, 1991, the FDIC published a Notice of Proposed Rulemaking ("First NPR")¹⁹⁰ proposing regulations implementing its authority under Section 1828(k), to limit golden parachute payments.¹⁹¹ The FDIC received 186 comment letters in response to the First NPR and took no further action on the First NPR.¹⁹² On March 29, 1995, the FDIC again issued a Notice of Proposed Rulemaking ("Second NPR")¹⁹³ regarding golden parachute payments,¹⁹⁴ which responded to many of the comments to the First NPR. Following the Second NPR, the FDIC issued its final rule on February 15, 1996.¹⁹⁵ The following section discusses selected major provisions set forth in the final rule, including a discussion of how the final rule evolved from the First NPR and Second NPR.

1. Bona Fide Deferred Compensation Plans

Congress provided the FDIC with the authority to exempt bona fide deferred compensation plans from the proscriptions on golden parachute payments.¹⁹⁶ Many commenters objected to the First NPR's

¹⁸⁶ *Id.* § 1828(k)(4)(A)(ii).

¹⁸⁷ A retirement plan is included in this exception if it is "qualified (or is intended to be qualified) under section 401 of Title 26 or other nondiscriminatory benefit plan." *Id.* § 1828(k)(4)(C)(i).

¹⁸⁸ The FDIC's determination may be made by regulation or order. 12 U.S.C. § 1828(k)(4)(C)(ii).

¹⁸⁹ *Id.* § 1828(k)(4)(C)(iii).

¹⁹⁰ 56 Fed. Reg. 50,529 (1991) (to be codified at 12 C.F.R. pt. 359).

¹⁹¹ The First NPR also proposes regulations limiting indemnification payments. *Id.*

¹⁹² 60 Fed. Reg. 16,069 (1995) (to be codified at 12 C.F.R. pt. 359).

¹⁹³ *Id.* The Second NPR indicates that the FDIC decided to issue a second set of proposed rules rather than final rules "[d]ue to the significant amount of time which has passed since the publication of" the First NPR. *Id.*

¹⁹⁴ The Second NPR also contained proposed rules regarding indemnification payments.

¹⁹⁵ 61 Fed. Reg. 5,927 (1996).

¹⁹⁶ See *supra* note 171 and accompanying text.

requirement that a bona fide deferred compensation plan be funded in order to fall outside of the definition of golden parachute payments.¹⁹⁷ These commenters noted the Internal Revenue Code's recognition of unfunded plans and the large number of existing unfunded plans that would be disrupted by the inclusion of such plans in the prohibited golden parachutes.¹⁹⁸ The FDIC responded to these comments in the Second NPR by deleting the funding requirement.¹⁹⁹ The final rule defines a bona fide deferred compensation plan as any agreement under which an IAP voluntarily elects to defer his or her compensation²⁰⁰ and the bank or bank holding company either "[r]ecognizes compensation expense and accrues a liability for the benefit payments according to generally accepted accounting principles"²⁰¹ or "segregates or otherwise sets aside assets in a trust which may only be used to pay plan and other benefits."²⁰² The proposed regulation also contains specific provisions including certain nonqualified deferred compensation and supplemental retirement plans within the definition of bona fide deferred compensation plans.²⁰³

2. Severance Pay Plans

Also exempted from the definition of golden parachute payments are certain severance pay plans. Several limitations apply to this exemp-

¹⁹⁷ 60 Fed. Reg. 16,069, 16,071 (1995).

¹⁹⁸ *Id.*

¹⁹⁹ *See id.*

²⁰⁰ Specifically, this portion of the regulation provides that a bona fide deferred compensation plan means:

any plan, contract, agreement or other arrangement whereby . . . [a]n IAP voluntarily elects to defer all or a portion of the reasonable compensation, wages or fees paid for services rendered which otherwise would have been paid to such party at the time the services were rendered (including a plan that provides for the crediting of a reasonable investment return on such elective deferrals)

12 C.F.R. § 359.1(d)(1) (1995).

In its comment letter to the Second NPR, the American Bankers Association ("ABA") noted that the proposed regulation is unclear as to the treatment of a plan that provides for an unreasonable investment return. This issue turns on whether an unreasonable investment return takes the whole plan out of the bona fide exemption or just treats the unreasonable portion as a prohibited golden parachute payment. The ABA recommended that only the unreasonable portion of the investment return constitute a prohibited golden parachute payment. Letter from Paul Alan Smith, Senior Federal Administrative Counsel, Federal Agency Relations, American Bankers Association to Mr. Robert E. Feldman, Acting Executive Secretary, FDIC (May 31, 1995). In its final rulemaking release, the FDIC confirmed that only "that portion of the investment return which is found to be unreasonable would be a prohibited golden parachute payment." 61 Fed. Reg. 5,927 (1996).

²⁰¹ 12 C.F.R. § 359.1(d)(1)(i).

²⁰² *Id.* § 359.1(d)(1)(ii). The regulation notes that such trust assets "may be available to satisfy claims of the institution's or holding company's creditors in the case of insolvency." *Id.*

²⁰³ *Id.* § 359.1(d)(2) and (3).

tion. First, the severance pay plan must be nondiscriminatory, providing the benefits to all eligible employees.²⁰⁴ Second, the plan must be provided "to all eligible employees upon involuntary termination other than for cause, voluntary resignation, or early retirement."²⁰⁵ Third, employees receiving payments under the plan may not receive more than an amount equal to their base compensation during the twelve months preceding their termination. Payment of greater benefits may only be made upon consent of the FDIC.²⁰⁶ This provision represents a change from the rule proposed in the First NPR which provided that severance benefits could not exceed six months in salary.²⁰⁷ Fourth, the plan may not have been adopted or modified to increase severance benefits at a time when the bank or bank holding company is financially troubled.²⁰⁸ The FDIC eliminated the requirement set forth in the Second NPR that no payment may be made to a senior executive officer without providing 30 days prior written notice to the FDIC and the AFBA.²⁰⁹ The FDIC concluded, after consideration of comments, that "the advantages of the prior notice provision for severance payments to senior executive officers do not outweigh the burden such a requirement would place on the industry, so this requirement has been deleted."²¹⁰

²⁰⁴ 12 C.F.R. § 359.1(f)(2)(v). The regulation provides that "nondiscriminatory" means: [t]hat the plan, contract or arrangement in question applies to all employees of [a bank] or [bank holding company] who meet reasonable and customary eligibility requirements applicable to all employees, such as minimum length of service requirements. A nondiscriminatory plan, contract or arrangement may provide different benefits based only on objective criteria such as salary, total compensation, length of service, job grade or classification, which are applied on a proportionate basis . . . to groups of employees consisting of not less than the lesser of 33 percent of employees or 1,000 employees.

Id. § 359.1(j). The FDIC explains that the purpose of this portion of the regulation is to prevent severance pay plans that would circumvent the purpose of the regulation. 61 Fed. Reg. at 5,928. The FDIC elaborates, by way of example:

In other words, as an example, to permit severance payments of one year's salary to the top five senior executive officers of an insured depository institution in contrast to one week's salary to all tellers on the basis that such payments are made pursuant to a *bona fide* severance pay plan, a recognized exception to the golden parachute prohibition, would undermine the purpose of [the Act].

Id.

²⁰⁵ *Id.* § 359.1(f)(2)(v). This provision was changed from the proposed rule in the Second NPR which provided that the severance plan must be provided in conjunction with a "reduction in force instituted by the bank or bank holding company." 60 Fed. Reg. at 16,079 (to be codified at 12 C.F.R. § 359.1(f)(2)(v)).

²⁰⁶ 12 C.F.R. § 359.1(f)(2)(v).

²⁰⁷ 56 Fed. Reg. at 50,531; 60 Fed. Reg. at 16,071.

²⁰⁸ 12 C.F.R. §§ 359.1(f)(2)(v), 359.1(f)(1)(ii)(A)-(E). The proposed regulation reiterates the statutory criteria regarding an institution's troubled status. *See supra* text accompanying notes 168-70.

²⁰⁹ 60 Fed. Reg. at 16,080 (to be codified at 12 C.F.R. § 359.1(f)(2)(v)).

²¹⁰ 61 Fed. Reg. at 5,927.

3. White Knight Exception

The new regulation provides that certain golden parachute payments are permissible. One such payment is included in the "White Knight" exception which permits agreements to make golden parachute payments to the extent that the agreement is made so that the bank or bank holding company may hire an IAP at a time when the bank or bank holding company is or is about to be troubled financially.²¹¹ The final rule illustrates the FDIC rejection of comments to the First and Second NPR suggesting that the White Knight exception be extended to include current bank officers and employees who are promoted to executive positions during a time when the institution is troubled.²¹² In the Second NPR, the FDIC acknowledged that talented new management can be found from within the institution but concluded that:

[T]he underlying reason for allowing what would otherwise be a prohibited golden parachute payment is not present in the case of a current employee who is promoted to an executive position. . . . [T]his type of severance payment will be approved in limited circumstances as a way to entice competent management to sever established ties with their current employer and take a calculated risk that they can assist in bringing a troubled institution back to financial health. This rationale does not apply to the case of a current employee of a troubled institution since he/she does not need to be enticed to give up an established, stable career with another employer.²¹³

The FDIC reiterated the same rationale in the final rule notice.²¹⁴ A bank or bank holding company could, on a case-by-case basis,

²¹¹ 12 C.F.R. § 359.4. The regulation reiterates the statutory criteria regarding an institution's troubled status. *See supra* text accompanying notes 147-49. The proposed rule in the First NPR only applied to hiring by banks or bank holding companies that were currently in troubled status. 56 Fed. Reg. at 50,531; 60 Fed. Reg. at 16,072.

²¹² 60 Fed. Reg. at 16,072; 61 Fed. Reg. at 5,928.

²¹³ 60 Fed. Reg. at 16,072. In its comment letter addressing the Second NPR, the Independent Bankers Association ("IBA") objected to the FDIC's failure to extend the white knight exception to current bank employees. The IBA urged, "the FDIC should not bar the possibility that a rescuer can be found within the employee ranks as long as the employee did not contribute to the troubled condition." Letter from Richard L. Mount, President, IBA, to Robert E. Feldman, Acting Executive Secretary, FDIC (May 30, 1995).

²¹⁴ 61 Fed. Reg. at 5928.

request the FDIC's permission to enter into an agreement with a current employee as described above.²¹⁵ Given the FDIC's stated rationale, however, it appears unlikely that the FDIC will approve such transactions.

4. Changes in Control

The new regulation allows severance payments, not exceeding twelve months salary, to an "IAP in the event of a change in control" of the bank, provided that the bank receive the prior consent of the AFBA.²¹⁶ This provision was added in response to commentators to the First NPR who suggested that certain arrangements designed to protect executive officers in the event of a hostile takeover be exempted from the prohibitions on golden parachute payments.²¹⁷ They reasoned that such arrangements ensure that executive officers' decision-making during takeover negotiations is "not influenced by the acquisition's ultimate effect on their employment."²¹⁸ The FDIC rejected this proposed additional exemption, reasoning that such an exemption would "open the door to the possibility of payments being made to [IAPs] who are substantially responsible for the [bank's] troubled condition."²¹⁹ The FDIC concluded that arrangements in the context of changes in control are best dealt with on a case-by-case basis—allowing such arrangements only with the FDIC's prior written consent.²²⁰

Commentators to the Second NPR were also critical of the one-year cap.²²¹ The FDIC responded:

[O]ne year's salary appears to be a reasonable compromise between a prohibition on any payment and more generous payments. The FDIC is of the opinion that one year's salary will provide ample incentive for an IAP (usually a senior executive officer) to objectively consider a takeover bid which may result in the loss of that IAP's job.²²²

²¹⁵ The regulation contains a general provision allowing for banks or bank holding companies to enter into otherwise prohibited golden parachute payments with the written concurrence of the FDIC. 12 C.F.R. § 359.4(a)(1).

²¹⁶ *Id.* § 359.4(a)(3).

²¹⁷ 60 Fed. Reg. at 16,072.

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.* at 16,081 (to be codified at 12 C.F.R. § 359.4(a)(1)).

²²¹ 61 Fed. Reg. at 5,928.

²²² *Id.*

5. Effect of the Timing of Troubled Status

The new regulation provides that the prohibitions on golden parachute payments apply only to IAPs who terminate employment at a time when the bank or bank holding company is troubled or in contemplation of it becoming troubled.²²³ The result is that the regulation has no impact on IAPs who, for example, begin to receive retirement benefits prior to the institution becoming financially troubled.²²⁴ Moreover, the regulation's prohibitions would not apply to an IAP who terminates employment after the institution is no longer financially troubled.²²⁵ If, however, an IAP terminates at a time when the institution is financially troubled and the institution regains a healthy condition, any golden parachute payments to that IAP will continue to be prohibited by the proposed regulation.²²⁶ Commenters to the Second NPR objected, arguing that safety and soundness concerns would be addressed by simply suspending golden parachute payments during the period that an institution is troubled but allowing the payments to be made if an institution recovers despite the fact that the IAP terminated during the troubled period.²²⁷ The FDIC rejected this position. The FDIC found that the regulation is consistent with the language of the statute.²²⁸

6. Effect on Receiverships

The new regulation will not affect the FDIC's rights when acting as receiver. The regulation provides that:

The provisions of this part, or any consent or approval granted the provisions of this part by the FDIC (in its corporate

²²³ 12 C.F.R. § 359.1(f)(1)(ii). The proposed regulation reiterates the statutory criteria regarding an institution's troubled status. See *supra* text accompanying notes 147-49.

²²⁴ 60 Fed. Reg. at 16,073.

²²⁵ *Id.*

²²⁶ *Id.*; 61 Fed. Reg. at 5,928.

²²⁷ The general counsel of UJB Financial Corp. urged that "[t]here is no evidence to support the view that one who leaves or is terminated *during* the troubled period is more likely to be substantially responsible for the troubled condition than one leaving before or after." Letter from Richard F. Ober, Jr., Executive Vice President, General Counsel and Secretary, UJB Financial Corp., to Robert E. Feldman, Acting Executive Secretary, FDIC (May 23, 1995). The General Counsel of People's Bank argued that the "sole purpose of this ongoing prohibition would seem to be punitive, but the punishment involved here is inequitable and bears no relationship to whether the affected IAP bore responsibility for the condition of the institution." Letter from William T. Kosturko, General Counsel, Legal Department, People's Bank, to Robert E. Feldman, Acting Executive Secretary, FDIC (May 30, 1995).

²²⁸ 61 Fed. Reg. at 5,928.

capacity), shall not in any way bind any receiver of a failed [bank]. Any consent or approval granted under the provisions of this part by the FDIC or any other federal banking agency shall not in any way obligate such agency or receiver to pay any claim or obligation pursuant to any golden parachute, severance . . . or other agreement. Claims for employee welfare benefits or other benefits which are contingent, even if otherwise vested, when the FDIC is appointed as receiver for any [bank], including any contingency for termination of employment, are not provable claims or actual, direct compensatory damage claims against such receiver.²²⁹

The FDIC provides little insight regarding the purpose of this provision. The Second NPR states that the fact that the FDIC or any other banking agency consents to certain payments covered by this regulation does not mean that the receiver will be obligated to make such payments or that the recipient of such payments will receive a preference over other creditors.²³⁰

The Second NPR also fails to provide an explanation for the purpose of the language providing that claims that are contingent at the time the FDIC is appointed as receiver are not provable claims or actual, direct compensatory damage claims.²³¹ It is clear, however, that this provision is aimed at enhancing the FDIC's right as receiver to repudiate certain contracts.²³² Through the FDIC's statutory rights of repudiation discussed in Part III, the FDIC has the power to repudiate certain contracts, including, for example, severance agreements, if the FDIC determines that the contract is burdensome.²³³ The statute provides that upon repudiation, the FDIC need only pay "actual, direct compensatory damages"—the meaning of which is the subject of several conflicting federal court decisions.²³⁴ This portion of the proposed regulation appears to be an attempt by the FDIC to memorialize its interpretation of the repudiation statute in an indirectly related regulation.²³⁵

²²⁹ 12 C.F.R. § 359.7 (1996).

²³⁰ 60 Fed. Reg. at 16,077.

²³¹ See *id.*

²³² See *infra* notes 245–87 and accompanying text (discussing FDIC's statutory right to repudiate certain contracts).

²³³ See *infra* notes 245–87 and accompanying text.

²³⁴ See *infra* notes 274–87 and accompanying text.

²³⁵ One commentator to the Second NPR described this provision as:

[a]n attempt—well disguised to readers not familiar with failed bank commercial

The American Association of Bank Directors ("AABD") strongly criticized the receivership portion of the regulation, noting that while the regulation recognizes that some golden parachute type payments may be beneficial to a bank, in that they enable the bank to attract or retain qualified employees, the receivership portion of the proposed regulation provides "that if the best efforts of these people fail and the institution goes under, they will not be entitled to the severance and benefits on which they relied when they agreed to work."²³⁶ Despite this strong criticism, this portion of the regulation as proposed in the Second NPR is unchanged in the final version of the rule.²³⁷ Moreover, the FDIC does not address this issue, as it does with most other significant comments, in its notice of final rulemaking.

III. FAILED INSTITUTIONS: FDIC'S POWERS AS RECEIVER

A. *FDIC's Role as Receiver: An Overview*

The powers to restrict banks' compensation practices discussed in parts I and II are conferred on the banking agencies as regulators of their respective financial institutions. In addition to these powers, the FDIC acts as receiver for failed banks.²³⁸ When a bank fails, the FDIC, as receiver, steps into the shoes of the failed bank and is responsible for liquidating the bank's assets and paying off creditors.²³⁹ To recoup losses incurred by the bank, the FDIC may rely on common law causes of action generally available to receivers or on the express statutory powers provided by Congress.

law but quite obvious to readers who are—to reverse by regulation the court cases that have permitted such pay and benefits in limited circumstances against failed institution receiverships. As FDIC knows, decisions in these cases have gone both ways depending on the facts and the courts' varying views of the law. It is inappropriate to try to reverse these court decisions in this manner. FDIC is not saving money for the taxpayers, because such claims are limited by the total resources of a given receivership.

Letter from David H. Baris, Executive Director, American Association of Bank Directors ("AABD"), to Robert E. Feldman, Acting Executive Secretary, FDIC (May 26, 1995). See *infra* part III.B.1.a–b (discussing court cases on this issue).

²³⁶ Letter from David H. Baris, Executive Director, AABD, to Robert E. Feldman, Acting Executive Secretary, FDIC (May 26, 1995).

²³⁷ See *supra* text accompanying note 180.

²³⁸ The FDIC must act as receiver for a failed national bank. The FDIC has the option to take over as receiver for a failed state-chartered bank. 12 U.S.C. § 1441a(m)(1) (1996); *id.* § 1813(j).

²³⁹ O'Melveny & Myers v. FDIC, 512 U.S. 79, 87 (1994). For a general discussion of the distinction between the FDIC's role as receiver and its role as insurer, see *Bullion Servs., Inc. v. Valley State Bank*, 50 F.3d 705, 709 (9th Cir. 1995) and *FDIC v. Godshall*, 558 F.2d 220, 221 n.3 (4th Cir. 1977) and *FDIC v. Abraham*, 439 F. Supp. 1150, 1151–52 (E.D. La. 1977).

In the context of compensation practices, the FDIC, as receiver, may sue former officers or directors of a failed bank for breach of fiduciary duty arising out of compensation paid to the former bank officials.²⁴⁰ While this power is considerable, it is beyond the scope of this article, since the power exercised by the FDIC in such cases is not fundamentally different than the power of a receiver of any non-bank corporation to sue for breaches of fiduciary duty.²⁴¹ Peculiar to the FDIC's role as receiver, however, are the many statutory powers that extend beyond what would be available under common law.²⁴² As discussed below, the FDIC's statutory power to repudiate contract obligations has a significant impact upon banks' compensation practices.

B. *Repudiation of Contract Obligations*

Under section 1821(e) of the FDIA, as amended by the Financial Institutions Reform Recovery Enforcement Act of 1989 ("FIRREA"), Congress empowered the FDIC, when acting as receiver for a failed bank, to repudiate contracts to which the failed bank is a party.²⁴³ The FDIC may exercise this statutory authority if it determines, in its discretion, that the contract is burdensome²⁴⁴ and the repudiation will promote the orderly administration of the institution's affairs.²⁴⁵ The

²⁴⁰ For a general discussion of common law relating to "excessive" compensation, see generally Elson, *supra* note 11, at 938; Barris, *supra* note 12, at 76.

²⁴¹ For a discussion of the possible statutory preemption in fiduciary duty cases, see Schooner, *supra* note 25, at 182-84.

²⁴² The term "receiver" means "a receiver, liquidating agent, conservator, commission, person, or other agency charged by law with the duty of winding up the affairs of a bank or savings association or of a branch of a foreign bank." 12 U.S.C. § 1813(j). The FDIC serves as receiver for failed commercial banks. *Id.* § 1441(a)(m)(1). Prior to its dissolution on December 31, 1995, the RTC served as receiver for failed savings associations. *Id.*

²⁴³ 12 U.S.C. § 1821(e)(1) (1996).

²⁴⁴ *Id.* § 1821(e)(1)(B). In *Union Bank v. FSLIC*, 724 F. Supp. 468, 470-71 (E.D. Ky. 1989), the court rejected the argument that a contract is "burdensome" only when it will cause actual loss to the institution. The court found that the "conservator may repudiate a contract the performance of which the conservator believes, in his discretion, would be detrimental to the conservation of the assets of the institution." *Id.* at 471. In an unpublished decision, the Fourth Circuit has held that the determination of burdensomeness is limited to the issue of whether the receiver abused its discretion. *Atlantic Mechanical, Inc. v. RTC*, No. 91-1500, 1992 U.S. App. LEXIS 904, at *6-8 (4th Cir. Jan. 27, 1992). The FDIC's discretion in determining burdensomeness has been interpreted broadly in compensation cases. See *Monrad v. FDIC*, No. 95-56221, 1995 U.S. App. LEXIS 20700, at *7-8 (9th Cir. Mar. 6, 1995).

²⁴⁵ 12 U.S.C. § 1821(e)(1)(C). Whether the receiver or conservator has repudiated within a reasonable time depends upon the circumstances of the case. *RTC v. Cedarminn Bldg. Ltd. Partnership*, 956 F.2d 1446, 1455 (8th Cir.), *cert. denied*, 506 U.S. 830 (1992); *Union Bank v. FSLIC*, 724 F. Supp. 468, 471 (E.D. Ky. 1989). The Second and Eighth Circuits have both held that the FDIC and RTC have a reasonable period to exercise their power of repudiation following appointment as receiver, even if they previously acted as conservator for the same institution.

FDIC must exercise its right to repudiate within a "reasonable period" following its appointment as receiver or conservator.²⁴⁶ If the FDIC makes the decision to repudiate a contract, it will be liable for damages.²⁴⁷ The FDIC's liability, however, is limited to "actual, direct compensatory damages"²⁴⁸ determined as of the date of its appointment as receiver or conservator.²⁴⁹ "Actual, direct compensatory damages" does not include punitive or exemplary damages, damages for lost profits or opportunity or damages for pain and suffering.²⁵⁰

Compensation arrangements have generated considerable litigation under section 1821(e).²⁵¹ As discussed below, many cases have arisen as a result of the FDIC's unwritten policy of refusing to pay severance claims made by employees of failed banks.²⁵² Other cases have arisen from the FDIC's refusal to pay certain retirement benefits. Two legal issues govern the analysis in these cases. First, courts have considered the scope of the FDIC's authority to repudiate contracts. Second, courts have considered whether, assuming the repudiation was authorized by the statute, the FDIC is liable for damages.

1. Scope of the FDIC's Authority to Repudiate

The first question the courts have considered in cases dealing with the FDIC's attempt to repudiate compensation arrangements is whether the FDIC has the authority to repudiate. This issue has centered on whether the FDIC may repudiate executory contracts²⁵³ but

1185 Ave. of the Amis. Assocs. v. RTC, 22 F.3d 494, 498 (2d Cir. 1994); *Cedarminn*, 956 F.2d at 1451-52. The Eighth Circuit's opinion in *Cedarminn* suggests that the party challenging the repudiation must show some prejudice to prove that the time the FDIC or RTC expended was unreasonable. 956 F.2d at 1455-56.

²⁴⁶ 12 U.S.C. § 1821(e) (2).

²⁴⁷ *Id.* § 1821(e) (3).

²⁴⁸ *Id.* § 1821(e) (3) (A) (i).

²⁴⁹ *Id.* § 1821(e) (3) (A). Damages incurred on or after the receiver or conservator's appointment are not recoverable. See *Office & Prof'l Employees Int'l Union v. FDIC*, 813 F. Supp. 39, 42 (D.D.C. 1993). But see *Employee Retirement Sys. v. RTC*, 840 F. Supp. 972, 985 n.14 (S.D.N.Y. 1993) (court used date of repudiation, despite "literal terms of the statute" because both parties to suit assumed that date as proper one for determination of damages). Damages for certain qualified financial contracts are determined as of the date of repudiation. 12 U.S.C. §§ 1821(e) (3) (A) (ii), (c) (8).

²⁵⁰ *Id.* § 1821(e) (3) (B).

²⁵¹ Section 1821(e) has also generated considerable litigation with regard to many other types of contracts. See generally Carol Anne Sennello, Note, *FIRREA's Damage Provisions: Inequitable, Unnecessary, and Costly to Boot*, 45 DUKE L.J. 183 (1995).

²⁵² See, e.g., *Hennessy v. FDIC*, 858 F. Supp. 483, 487 (E.D. Pa. 1994).

²⁵³ An executory contract is one "under which neither party has performed his or her obligation under the contract." *LaMagna v. FDIC*, 828 F. Supp. 1, 2 (D.D.C. 1993).

not nonexecutory²⁵⁴ contracts on the theory that allowing the FDIC to repudiate a nonexecutory contract, i.e., one where the plaintiff has already performed, leads to draconian results.²⁵⁵ The United States District Court for the District of Columbia has concluded that section 1821(e) permits the FDIC to repudiate executory contracts, but not contracts where the plaintiff (employee, in the context of compensation cases) has performed.²⁵⁶ Other courts have been reluctant to adopt the distinction because the statute does not distinguish between executory and nonexecutory contracts.²⁵⁷ Some courts have avoided deciding the issue because the distinction does not impact the result of the case,²⁵⁸ i.e., the FDIC must pay the same damages whether or not the court finds that it has the statutory authority to repudiate the contract.²⁵⁹

In *Fresca v. FDIC*, the United States District Court for the Southern District of New York provided one of the more complete analyses of this issue (although the court declined ultimately to decide the issue).²⁶⁰ The court examined the statutory language allowing the FDIC to "disaffirm or repudiate" contracts. The court explained: "Both terms suggest a stage of the contract where performance on the part of the FDIC is not yet due. In other words, repudiation entails an anticipatory breach, taking place before the triggering event occurs which would cause the other party's rights to vest."²⁶¹ The court concluded that the FDIC has the authority to repudiate executory contracts, which it defined as "contracts where rights of the parties have not vested."²⁶² The court, however, questioned the FDIC's power to repudiate contracts where the rights of the employee have vested, i.e., nonexecutory

²⁵⁴ A nonexecutory contract is "one under which liability for performance has accrued because one party has performed his or her contractual obligations." *Id.*

²⁵⁵ See *Fresca v. FDIC*, 818 F. Supp. 664, 668 (S.D.N.Y. 1993). The result, however, does not seem particularly draconian when one considers that § 1821(e) requires the FDIC to pay damages when it repudiates a contract. 12 U.S.C. § 1821(e)(3) (1996).

²⁵⁶ *LaMagna*, 828 F. Supp. at 2.

²⁵⁷ *Morton v. Arlington Heights Fed. Sav. & Loan Ass'n*, 836 F. Supp. 477, 481 (N.D. Ill. 1993) ("We would be loathe to read the word 'executory' into the statute unless to omit it would lead to an absurd or unjust result."); *Majeski v. RTC*, No. 94-738, 1995 WL 115953, *3 (D.D.C. Feb. 28, 1995) ("FIRREA explicitly gives the receiver discretion to disaffirm or repudiate 'any contract' and does not limit that discretion to situations involving executory contracts.")

²⁵⁸ *Marsa v. Metrobank for Sav.*, F.S.B., 825 F. Supp. 658, 666 (D.N.J. 1993); *Fresca v. FDIC*, 818 F. Supp. 664, 668-69 (S.D.N.Y. 1993).

²⁵⁹ Because the statute places limitations on recoverable damages, however, the acceptance of this distinction could be important in some cases. See *supra* notes 248-50 and accompanying text (discussing limitation of damages to "actual, direct compensatory damages").

²⁶⁰ *Fresca*, 818 F. Supp. at 668-69.

²⁶¹ *Id.* at 668.

²⁶² *Id.*

contracts.²⁶³ The court ultimately dismissed this issue since it would not affect the outcome of the case, i.e., the plaintiffs would receive the same damages if the court found that the FDIC had the power to repudiate the contract or if the court found that the FDIC did not.²⁶⁴

As discussed above, in many cases the question of whether section 1821(e) allows the repudiation of nonexecutory contracts proves non-dispositive. Still, the analysis may have importance in addressing the issue of damages discussed below. The *Fresca* decision suggests that Congress, by using the terms "disaffirm or repudiate," contemplated the repudiation of contracts where the rights of the parties have not yet vested. As discussed below, the question of whether or not the plaintiff's rights under the contract have vested is an important issue in some cases addressing the issue of what damages are due under section 1821(e).

2. Damages for Repudiation

In compensation cases, courts have considered two issues in determining whether the FDIC is liable for damages under the statute. The first question is whether, as a threshold matter, the plaintiff has incurred any damages. The resolution of this question usually revolves around the question of whether or not the plaintiff's rights under the repudiated contract vested prior to the appointment of the FDIC as receiver. Even if the plaintiff satisfies the court that he or she has incurred some damage, the issue remains whether the damages claims are actual, direct compensatory damages or damages that are not recoverable under the statute, such as punitive or exemplary damages.²⁶⁵ Below is a discussion of each of these issues.

a. *Did the Plaintiff Incur Damages?*

Damages owed by the FDIC under section 1821(e) are determined as of the date of its appointment as receiver. Therefore, courts have addressed whether or not, as of that date, the plaintiff has any claim for damages.²⁶⁶ In *Office and Professional Employees International Union Local 2 v. FDIC*, the District of Columbia Circuit addressed whether the FDIC, acting as receiver for The National Bank of Washington

²⁶³ *Id.*

²⁶⁴ *Id.* at 669.

²⁶⁵ See *infra* notes 274-87 and accompanying text.

²⁶⁶ If the court determines that the plaintiff incurred damages as of that date, then the court must determine whether those damages are the type of damages recoverable under the statute, i.e., actual, direct compensatory damages.

("NBW"), was liable for severance payments under a collective bargaining agreement which the FDIC repudiated.²⁶⁷ Relying on the statutory requirement that damages for repudiation be determined as of the date of the appointment of the receiver, the FDIC asserted that the NBW employees were not entitled to damages because their right to severance pay had not accrued at the time of the appointment of the FDIC as NBW's receiver.²⁶⁸ This argument was based upon the fact that the employees were not entitled to severance pay until termination of their employment for economic reasons, and the employees were not so terminated until after the FDIC was appointed receiver. The court rejected the FDIC's argument, finding that the right to severance payments was vested prior to termination.²⁶⁹ The court reasoned that although the employer's obligation to pay under a severance agreement "attaches only if an employee was [sic] laid off for economic reasons, it can hardly be suggested that this sort of protection lacks any immediate value."²⁷⁰ Conversely, in *Hennessy v. FDIC*, the Eastern District of Pennsylvania came to the opposite conclusion. In *Hennessy*, the court found that severance benefits did not vest where employees were not terminated prior to the FDIC's appointment as receiver.²⁷¹

Arguably, however, the focus of this issue has gone astray. In recalling the Southern District of New York's decision in *Fresca*, the emphasis on whether or not the plaintiff's rights had vested at a particular point in time appears misplaced.²⁷² As the court in *Fresca* indicated, the language of section 1821(e) suggests that contracts under which rights have not yet vested are the only types of contracts which Congress granted the FDIC the authority to repudiate.²⁷³ Since

²⁶⁷ 27 F.3d 598, 601 (D.C. Cir. 1994).

²⁶⁸ *Id.* at 600.

²⁶⁹ *Id.* at 601. The court noted, however, that the value of the employee's vested rights, at any time prior to termination, must be "discounted for the risk that the employees would not be discharged for economic reasons, for instance, that the employees would quit, retire, die, or be discharged for misconduct." *Id.*; see also *Majeski*, 1995 WL 115953, at *3 (plaintiff's right to retirement benefits vested as of the appointment of the RTC as receiver); *LaMagna*, 828 F. Supp. at 3 (plaintiff's severance benefits vested upon signing of the severance agreement); *Marsa*, 825 F. Supp. at 664 (plaintiff's rights under a settlement agreement had already vested at the time of appointment of the RTC as receiver).

²⁷⁰ *OPEIU*, 27 F.3d at 602.

²⁷¹ 858 F. Supp. 483, 487 (E.D. Pa. 1994). Even after concluding that the plaintiff's rights had not vested prior to the receivership, the court includes in its opinion an analysis of whether the damages claimed by the plaintiff are the type of damages recoverable under the statute. *Id.* at 488-89. This perhaps indicates that the court did not view the question of vesting as dispositive on the damages question.

²⁷² See *supra* notes 141-43 and accompanying text.

²⁷³ See *supra* notes 142-43 and accompanying text.

it is clear that Congress intended the FDIC to be liable for at least some damages for repudiation, interpreting the statute to require that contract rights must be vested in order to claim such damages would make the statute internally inconsistent. Perhaps, by including in the statute the requirement that the damages for repudiation be determined as of the date of the FDIC's appointment as receiver, Congress merely intended to limit the further accrual of damages following the receivership. The limitation of further accrual of damages could be significant in certain cases—for example, with any contract calling for the payment of interest charges. In the case of severance benefits, however, which are generally payable in one lump sum, there is no further accrual problem, i.e., the damages do not grow over time.

b. *Are the Damages Actual Direct Compensatory Damages?*

At least three federal circuit courts have considered the question of whether the FDIC's repudiation of a severance agreement results in actual, direct compensatory damages under section 1821(e). The United States Court of Appeals for the First Circuit first addressed this issue in *Howell v. FDIC*.²⁷⁴ In *Howell*, four officers of Eliot Savings Bank entered into severance agreements under which the bank agreed to pay each officer—the equivalent of three year's salary for one of the officers and one year's salary for each of the other three officers—if their employment were terminated. While the agreements did not obligate the officers to remain at the bank for any fixed term, the bank promised to make the severance payments "in consideration of the officers' 'willingness to remain' in the bank's employ."²⁷⁵ Less than a year later, the bank failed, and the FDIC was appointed as its receiver.²⁷⁶ The FDIC repudiated the severance agreements. In the ensuing litigation, the central issue on appeal was whether the amounts due under the severance agreements constituted actual direct compensatory dam-

²⁷⁴ 986 F.2d 569, 573 (1st Cir. 1993). The First Circuit, in addressing a broad range of issues, has relied upon its decision in *Howell*. See, e.g., *DPJ Co. Ltd. Partnership v. FDIC*, 30 F.3d 247, 248–49 (1st Cir. 1994); *Lawson v. FDIC*, 3 F.3d 11, 14–15 (1st Cir. 1993); *Heno v. FDIC*, 996 F.2d 429, 433 (1st Cir. 1993).

²⁷⁵ *Howell*, 986 F.2d at 570. The court indicates that the agreements did not alter the "at will" nature of the employment relationship between the bank and the officers, since the bank could terminate the officers at any time, and the officers could leave the bank's employ at any time. *Id.* The court's observation on this point is perplexing. The severance arrangements appear to have had a significant effect on the "at will" nature of the employment contract, since the arrangements alter the consequences of either party's termination without cause, i.e., if the bank terminated the employee, the bank had to pay severance; if the employee quit, the employee forfeited the severance payment.

²⁷⁶ *Id.* at 571.

ages under section 1821 (e). The First Circuit concluded that the amounts due under the severance agreements did not constitute actual, direct compensatory damages. The court reasoned:

Severance payments, stipulated in advance, are at best an estimate of likely harm made at a time when only prediction is possible. When discharge actually occurs, the employee may have no way to prove the loss from alternative employments foregone, not to mention possible disputes about the discharged employee's ability to mitigate damages by finding new employment. A severance agreement properly protects against these uncertainties by liquidating the liability. Such payments comprise or are analogous to "liquidated damages," at least when the amount is not so large as to constitute an unenforceable penalty

Unfortunately for the appellants, the statutory language—"actual, direct compensatory damages"—did not quite embrace the payments promised by the officers' severance agreement. Eliot's officers may, or may not, have suffered injury by remaining at the bank, depending on what options they had in the past that were not available at the time of severance. Conceivably, they suffered no damage at all; conceivably, their actual damages from staying at Eliot exceed the amounts stipulated in the agreements. The point is that severance payments of this class do not comprise actual damages.²⁷⁷

The First Circuit's characterization of the amounts due under the severance agreements as liquidated damages is mistaken.²⁷⁸ Liquidated damages represent the contracting parties' agreement, prior to breach, as to the remedy for breach of their contract.²⁷⁹ If severance payments were a form of liquidated damages, the severance payment would represent the employer's and employee's estimate of the damages owed to the employee for the employer's breach of the employment contract. The employment contract in *Howell*, however, was an at-will contract—as are most employment contracts. Under an at-will con-

²⁷⁷ *Id.* at 573 (citations omitted).

²⁷⁸ At least one district court, however, has followed the First Circuit's decision. *See, e.g., Hennessy*, 858 F. Supp. at 487; *see also Credit Life Ins. Co. v. FDIC*, 870 F. Supp. 417, 425 (D.N.H. 1993) (citing *Howell* for proposition that once contract is disaffirmed or repudiated, the disaffirmance is treated as breach of contract); *Marsa*, 825 F. Supp. at 666; *Fresca*, 818 F. Supp. at 670.

²⁷⁹ *See generally* E. ALLAN FARNSWORTH, *CONTRACTS* § 12.18 (2d ed. 1990). As the court indicated, the principal restriction on liquidated damages is that such damages may not be so large as to constitute a penalty. *Id.*

tract, the employer would not be obligated to pay the employee damages for termination. It is precisely because the employer would not ordinarily owe the employee anything in the event of termination, that an employer may agree to pay some fixed amount to the employee as an incentive for the employee to remain on the job.²⁸⁰ Severance arrangements provide the employee with an incentive to stay on the job because the severance benefits are not payable to the employee if the employee quits.

The other circuit courts that have addressed this issue,²⁸¹ most importantly the United States Courts of Appeals for the District of Columbia Circuit and the Ninth Circuit, demonstrate a more precise understanding of the nature of severance arrangements. In *Office and Professional Employees International Union ("OPEIU") Local 2 v. FDIC*, the United States Court of Appeals for the District of Columbia Circuit rejected the First Circuit's conclusion that severance pay did not constitute actual direct compensatory damages.²⁸² The District of Columbia Circuit reasoned that the *Howell* decision overlooked the fact that "an employer's promise to make severance payments is part of the consideration of the employment contract."²⁸³ The court concluded that the severance arrangement was a modification of the at-will relationship and, therefore, gave rise to compensable damages under the statute.²⁸⁴ In *Monrad v. FDIC*, the United States Court of Appeals for the Ninth Circuit followed the decision in *OPEIU*, finding the FDIC liable for severance pay as an actual direct compensatory damage.²⁸⁵

Arguably, the difference between the results in *Howell*, *OPEIU*, and *Monrad* can be explained on the basis of their facts. The claims of the plaintiffs in *Howell* appear far less compelling than the plaintiffs' claims in *OPEIU* and *Monrad*. The plaintiffs in *Howell* were four bank officers who entered into agreements that provided them with a payment of one year's salary upon their termination. Apparently, there

²⁸⁰ This was the stated purpose of the severance arrangements in *Howell*. See *supra* note 275 and accompanying text.

²⁸¹ See also *RTC v. Management, Inc.*, 25 F.3d 627, 631-32 (8th Cir. 1994) (citing *Howell* for propositions that: (1) repudiation is normally treated as breach of contract that gives rise to ordinary contract claim for damages; (2) by repudiating contract, RTC is freed from duty of compliance; and (3) neither severance fees nor future lost profits are compensable under FIRREA).

²⁸² 27 F.3d 598, 604 (D.D.C. 1994).

²⁸³ *Id.* at 603.

²⁸⁴ *Id.* at 604.

²⁸⁵ 62 F.3d 1169, 1170 (9th Cir. 1995). The court also rejected the FDIC's argument that *OPEIU* was distinguishable because the severance pay in that case was part of a collective bargaining agreement. See *id.* at 1173.

was some suggestion by the FDIC that the agreements themselves were the result of improper insider influence "to assure themselves of a handsome farewell gift from a failing bank."²⁸⁶ In contrast, the plaintiffs in both *OPEIU* and *Monrad* were recipients of severance benefits under umbrella bank policies, not special arrangements made for their individual benefit. The *OPEIU* and *Monrad* decisions make no mention of the possibility that such policies were improper or that the plaintiffs had any influence in setting such policies.

Any such factual distinctions between the cases, however, should not have affected their outcome. The FDIC's power to repudiate is not an enforcement tool and should not be used to remedy abusive compensation arrangements. If the FDIC concludes that a severance arrangement is legally objectionable, i.e., an unsafe or unsound banking practice or a breach of fiduciary duty, the proper forum for such a determination would be through the institution of formal enforcement action.²⁸⁷

IV. ASSESSMENT OF THE REGULATION OF BANKS' COMPENSATION PRACTICES

The extensive²⁸⁸ government regulation of banks' compensation practices is a testament to the interest of lawmakers in this issue. The question remains whether the regulation is effective in balancing safety and soundness concerns with banks' need to compete in an increasingly competitive market for skilled professional talent. Part IV evaluates the agencies' limitations on compensation practices detailed in parts I, II and III by identifying and evaluating the primary assumptions regarding, and approaches toward, compensation that provide the foundations for regulatory intervention in this area of banks' internal operations.

A. *The Impact of Compensation Practices on Banks' Safety and Soundness*

Compensation practices are just one of the many kinds of banks' internal operations that draw regulatory scrutiny. As with other internal operations, the agencies' concern with compensation practices

²⁸⁶ See *Howell*, 986 F.2d at 573.

²⁸⁷ See *supra* notes 44–106 (discussing agencies' use of administrative enforcement powers in cases involving compensation arrangements).

²⁸⁸ Regulation of banks' compensation practices is certainly extensive when compared to the little regulation imposed on other non-bank companies. See *supra* notes 13–15 and accompanying text.

stems from the agencies' charge to preserve banks' safety and soundness. The following section discusses the link between compensation practices and safety and soundness.

The enforcement actions discussed in part I that are based upon claims that the compensation paid by the bank was "excessive" provide illumination of the regulatory interest in compensation practices. The agencies provide no definition for "excessive" in this context, but the term "excessive" could reasonably be interpreted as any amount that would impact a bank's financial condition.²⁸⁹ This definition, however, would not likely satisfy a regulator's goal of preserving the safety and soundness of a bank. A review of the excessive compensation cases brought by the agencies does not reveal consistent findings that the compensation paid impacted the bank's capital or liquidity, i.e., its financial condition.²⁹⁰ Rather, it is unlikely that such a showing could be made except in cases involving the most outrageous salaries paid by an institution on the brink of insolvency.²⁹¹

The regulatory concern with "excessive" payments, however, may extend well beyond a concern for the bank's bottom line. First, a bank's willingness to make "excessive" payments to certain officials may evidence a pattern of conduct in which bank management ignores the well-being of the bank in favor of its own interests (even if the bank can "afford" to pay the high salaries). Second, regulators have traditionally shown concern regarding the public's perception of the financial stability of banks.²⁹² Regardless of whether providing a bank CEO with a multimillion dollar compensation package would actually impact the financial condition of a bank, the agencies may be concerned that the public's confidence in banks may be undermined by such practices.²⁹³

²⁸⁹ The Fifth Circuit's interpretation of "unsafe or unsound banking practices" would mandate a finding that the practices had a "reasonably direct effect on [a financial institution's] financial soundness." *Gulf Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982). The agencies, however, have not adopted this limitation on the definition of "unsafe or unsound banking practices." *See supra* note 50.

²⁹⁰ While the agencies may relate the amount of compensation to a bank's financial condition, *see supra* note 56 and accompanying text, the agencies may look alternatively to other factors to determine excessiveness. *See supra* notes 54-55 and accompanying text.

²⁹¹ *See generally* Elson, *supra* note 11, at 949-50 (discussing impact of executive compensation on company's earnings).

²⁹² *See* *Investment Co. Inst. v. Camp*, 401 U.S. 617, 631 (1971) ("[P]ublic confidence is essential to the solvency of a bank . . .").

²⁹³ Many corporate executives are compensated with stock incentives, the payment of which does not impact the bottom line. This method of compensation, however, has not escaped public scrutiny. *See, e.g.*, Sarah Bowen, *Executive Pay (a Special Report): Enough! Shareholders Like the Idea of Using Stock as a Pay Incentive; But Now, Some Say, It Has Gone Too Far*, WALL ST. J., Apr. 11,

With the regulators' general interest in compensation practices as a backdrop, the remainder of this part discusses the specific foundations for the regulators' approach toward limiting compensation practices.

B. Compensation Used to Attract and Retain Employees

The banking agencies are cognizant of the tension between their goal of preserving banks' safety and soundness and the banks' need to attract, retain and motivate qualified employees.²⁹⁴ Because compensation is considered one of the factors affecting employers' ability to attract, retain and motivate their employees, the banking agencies must exercise caution in regulating compensation policies so that the regulation does not impede banks' ability to compete for human capital. As discussed below, the FDIC, however, has adopted a strict liability approach to the enforceability of severance agreements, i.e., it has rendered such agreements unenforceable in many instances without any finding of culpability on the part of the bank or its employees. As discussed below, this approach will likely impact negatively banks' ability to attract and retain employees.

FDIC regulations and practices demonstrate an animosity toward the enforceability of severance pay plans in the event a bank is insolvent or lands in receivership.²⁹⁵ Criticism of this approach would be difficult if the FDIC targeted only severance pay plans that were "abusive," i.e., entered into without regard to the safety and soundness of the bank.²⁹⁶ The FDIC, however, has not limited its intervention in this fashion. FDIC regulations limit a bank's ability to set severance payments or render severance pay plans unenforceable in the event of a bank's insolvency or receivership regardless of whether the plan is the result of any culpable conduct on the part of the bank or its officers. For example, the FDIC's new golden parachute regulation would require prior agency approval of any severance pay plan allowing for benefits that exceed one year's base compensation. The foundation for

1996, at R6; *Business Brief: BankAmerica Corp.: Stock-Based Plan Adopted for Executive Compensation*, WALL ST. J., Mar. 28, 1995, at C19; see also Jay Mathews, *Caution: Highly Paid Boss; Study Links Executive Pay to Risk Avoidance*, WASH. POST, May 1, 1996, at F1 (questioning whether executives who own large portions of their company's stock become overly cautious for fear of "cracking their nest egg").

²⁹⁴ See Joint Advance Notice of Proposed Rulemaking on Standards for Safety and Soundness, 57 Fed. Reg. 31,337 (1992).

²⁹⁵ See *supra* part I.B.1 (discussing OTS's regulation of employment contracts); part II.B.2 (discussing the FDIC's golden parachute restrictions); part II.B (discussing the FDIC's power to repudiate severance and other contracts providing compensation).

²⁹⁶ See *supra* part I.A.2 (discussing agency enforcement actions targeting compensation practices as unsafe or unsound banking practices).

this portion of the regulation must be that severance pay plans providing for greater benefits are presumptively suspect.²⁹⁷ The FDIC has not provided data or explanation regarding why plans offering greater benefits should be subject to this limitation. This leaves the disconcerting impression that the limitation is somewhat arbitrary. In addition, while the FDIC quite sensibly created an exception to the golden parachute prohibitions for contracts made with "white knights," the FDIC refused to extend the exception to current bank employees.²⁹⁸ The FDIC's rationale is that this exception is not needed with respect to current employees because they do not need to be "enticed to give up an established stable career with another employer."²⁹⁹ This rationale ignores the obvious fact that a bank's best employees are likely to have options for employment outside of their current situation, which may appear more and more attractive as their own bank's financial condition falters. It seems fundamental that troubled banks should be given the flexibility to craft employee incentives, be it compensation, promotions or other means, that will enable them to retain their best talent during troubled times.

Perhaps more troubling is the FDIC's position that its repudiation of severance agreements upon a bank's receivership does not result in actual direct compensatory damages which would be recoverable under section 1821(e) of the FDIA.³⁰⁰ In repudiation cases, described in part III, the FDIC is not required to prove any culpable conduct in connection with the severance agreement, as it would in an enforcement action described in part I.³⁰¹ In these cases, the FDIC is operating not as a regulator, but in its capacity as a receiver, the duty of which is to liquidate the bank's assets and pay off creditors. The problem that the FDIC's position creates with respect to a bank's ability to attract and retain the best employees is quite simple. Current or prospective

²⁹⁷ Certainly, we would suffer no heartache in seeing this regulation applied to the bank CEO with a million dollar annual salary. See, e.g., Nikhil Deogun, *First Union Takeover of First Fidelity to Bring Terracciano Large Payments*, WALL ST. J., Sept. 5, 1995, at A9 (discussing Mr. Terracciano's pending annual salary and bonus of not less than \$2,000,000, regardless of whether or not he leaves First Union—either voluntarily or involuntarily). The regulation, however, looks very different from the perspective of a teller earning a very modest salary who has been an employee with the bank for many years.

²⁹⁸ See *supra* part II.B.3.

²⁹⁹ 60 Fed. Reg. 16,072.

³⁰⁰ See *supra* part III.B.2. The FDIC's new golden parachute regulations make clear that this is the FDIC's current position. See *supra* part II.B.6. This is despite a split in the circuits on this issue. See *supra* part III.B.2.

³⁰¹ At least one court has criticized the RTC for insinuating culpability on the part of respondents where there was no evidence in the record. See *supra* note 136; see also *supra* note 275 and accompanying text (discussing the *Howell* decision).

bank employees might reasonably seek to negotiate some form of compensation for the risk they incur in staying employed by, or accepting employment with, a financially troubled bank (or any bank operating in a troubled economic market). Because, in the event of a receivership, the FDIC will take the position that it can repudiate severance pay plans without any obligation to pay damages, banks, in effect, are prevented from using such contracts as part of an enticing compensation package.

C. Comparison of Banks' Compensation Practices to the Compensation Practices of Their Competitors

The current regulation of banks' compensation practices reveals an assumption by the regulators that one of the appropriate ways to evaluate a bank's compensation practices (primarily for purposes of maintaining banks' safety and soundness) is to compare banks' practices to those of their competitors. The regulators have used this comparison as a basis for the finding of "excessive" compensation constituting unsafe or unsound banking practices in formal enforcement proceedings.³⁰² The agencies' interest in the comparison of compensation practices between banks and their competitors is not limited, however, to the expediciencies of proving violations of law by a respondent bank in an enforcement proceeding. The agencies also show an interest in the comparison for the proactive purpose of improving banks' internal operations (and thereby avoiding unsafe or unsound banking practices). Agency orders directing a review of a bank's compensation policies often direct the bank to consider the policies of other financial institutions.³⁰³ Most recently, the OCC's *Handbook on Emerging Market Country Products and Trading Activities* directs banks' senior management, among other things, to consider "competitors' compensation packages for similar responsibilities and performance" in establishing and reviewing compensation programs.³⁰⁴

Ostensibly, the comparison of a bank's compensation policies to its competitors' policies is useful because it enables a regulator (or the bank itself) to determine whether its compensation policies serve to

³⁰² See *supra* notes 57-58 and accompanying text. As discussed *supra* part I, this comparison can be used to satisfy the part of the definition of "unsafe or unsound banking practices" which requires a finding that the conduct is "contrary to accepted standards of banking operations." See *supra* note 57 and accompanying text.

³⁰³ See *supra* notes 102-06 and accompanying text.

³⁰⁴ See OCC, COMPTROLLER'S HANDBOOK: EMERGING MARKET COUNTRY PRODUCTS AND TRADING ACTIVITIES 18 (1995).

attract and retain quality employees or whether the policies tend to overcompensate employees as compared to their peers in other institutions. The use of such comparisons, however, can be problematic. First, as a practical matter, it may prove difficult to obtain the data necessary for comparison, or, even if the data is obtained, to use the data as a basis for comparison.³⁰⁵ For example, the job of a vice president in commercial lending in one bank may involve significantly different tasks and responsibilities from a job bearing the same title at a similarly situated financial institution. This obviously creates problems, although not necessarily insurmountable ones, in comparing the compensation paid to each. Second, compensation is an area of internal operations that is likely as amenable to innovation as any other area of bank operations. Therefore, banks, and other companies, should not necessarily be encouraged to follow simply the practices of their competitors (to satisfy regulators) when an innovative approach to compensation could prove a valuable part of the bank's competitive edge in a competitive marketplace.³⁰⁶

This is not meant to suggest that the regulators should encourage banks to ignore the compensation practices of their competitors³⁰⁷ or that comparisons of practices within the industry are meaningless in identifying safety and soundness concerns.³⁰⁸ Rather, regulators should exercise care in relying on such comparisons as a means of evaluation. Recent literature encourages all corporate boards, not just bank boards, to focus questions of compensation on the unique and current needs of their institutions rather than on industry practices.³⁰⁹

³⁰⁵ See MARC J. WALLACE & CHARLES H. FAY, *COMPENSATION THEORY AND PRACTICE* 28-49 (2d ed. 1988) (discussing use of external market data in setting compensation policies); see also Lauren Young, *Executive Pay (A Special Report): Compare and Contrast: More Pay Plans Are Linked to How Well a Corporation Fares Against Its Rivals; the Problem: Finding an Appropriate Rival*, WALL. ST. J., Apr. 11, 1996, at R8.

³⁰⁶ The recent use of sophisticated stock options and financial derivatives in compensation programs is evidence of the potential for innovation in this area. See Millstein, *supra* note 12, at 1437.

³⁰⁷ Compensation theorists Wallace and Fay put it best:

[A] company that consistently pays wage rates below those prevailing in the external marketplace will find its ability to attract qualified employees in sufficient numbers and on a timely basis diminished. Eventually, they will be unable to attract any employees. Conversely, most employers who consistently pay more for labor than their competitors will lose a competitive edge and may either price their product out of the market or fail to make sufficient profits.

WALLACE & FAY, *supra* note 305, at 29.

³⁰⁸ While the failure of a bank to have compensation practices in line with its competitors may be a sign of the bank's ability to innovate, it could also be a sign of insider abuses.

³⁰⁹ A recent article:

Certainly the board can develop strategy as to executive compensation to a greater

D. *Regulation of the Process Versus the Package*

Parts I, II and III of this article illustrate the agencies' abilities to limit the content of compensation contracts.³¹⁰ Congress has given the agencies the power to take the position that the bank is paying its executives, directors and employees "too much" and should not be permitted to do so. This approach puts the agencies in the position of scrutinizing the business judgments of bank managers relating to compensation. The following discussion questions whether the agencies' involvement in these types of business judgments is appropriate.

To the extent that there exists a problem in corporate America with overcompensation³¹¹ of executives,³¹² it stems from the structure of corporate governance. Professor Derek Bok described the problem as follows:

[M]ost top executives are in an unusually strong position to strike a favorable bargain, because they exert such influence over the process. CEOs almost always serve as chairman of the board. They typically have a good deal to say about the choice of new board members. They are the key people who decide on the fees paid to the directors, fees that average over \$40,000 for only a few days of work each year. They often choose the consultant who presents recommendations on their next pay increase to the board—and most consultants are only too aware that candor, restraint, frugality, and other Puritan virtues may not be warmly remembered when it comes to picking a successor for the following year. In this environment, the task of fixing the compensation of top executives

extent than is found in current practice. To do so, however, will require less reliance on industry 'standards' (what is everyone else paying), and more focus on compensation tied to share price and other indicators of performance unique to the corporation.

Millstein, *supra* note 12, at 1436.

³¹⁰ For examples, see part I.A.2.a(1)–(2) (discussing enforcement actions alleging excessive compensation and certain incentives as an unsafe or unsound banking practice); part I.A.2.b(1) (discussing cease and desist orders that limit compensation practices); part II.A (discussing limits on compensation for officers of undercapitalized institutions); part II.B (discussing limitations on golden parachute payments).

³¹¹ Some commentators take the position that there is no problem regarding executive overcompensation. See generally Elson, *supra* note 11, at 939 n.7 (citing various sources of this position).

³¹² While this article is not necessarily limited to a discussion of executive compensation, abusive compensation practices tend to arise at the executive level. The banking industry does not face headline news on excessive salaries for tellers or commercial loan officers.

is hardly an arms-length transaction comparable to setting the salaries of middle managers and other kinds of employees.³¹³

Commentators have suggested various solutions to the conflicts of interests described by Professor Bok. These solutions focus on aligning decisions regarding compensation to the interests of shareholders rather than the interests of corporate executives. Proposals for reform include: compensation of outside directors in stock only;³¹⁴ increased involvement of institutional investors who have the incentive and resources to ensure that compensation plans are directed toward shareholder interests;³¹⁵ changes in board composition to diffuse the power of the CEO;³¹⁶ and alignment of compensation with share price and other performance indicators.³¹⁷

Some agency efforts appear aimed toward eliminating the self-interest motivation from compensation decisions. For example, as discussed above,³¹⁸ some cease and desist orders call for the assistance of outside consultants in the development of compensation plans.³¹⁹ Other orders mandate a review of compensation decisions by an independent board committee.³²⁰

These measures, however, may not be the best means of addressing the problem of self-interest. The use of outside consultants has been criticized as an ineffective means of providing objective decision-making.³²¹ Consultants are hired and paid by executive management. Due to these consultants' own pecuniary interests, their recommendations are not likely to stray far from the wishes of management. The use of independent board committees, often referred to as compensation committees, is also a flawed means of providing objectivity in compensation decisions. One commentator provided this critical assessment of the objectivity of compensation committees:

The composition of these committees negates any pretense of their impartiality . . . while the corporate environment in

³¹³ Bok, *supra* note 12, at 98.

³¹⁴ Arguably, this ties the interests of outside directors more closely to shareholders, rather than current corporate management. See, e.g., Elson, *supra* note 11, at 939 (also recommending increased director term lengths); Millstein, *supra* note 12, at 1436-39.

³¹⁵ Barris, *supra* note 12, at 99.

³¹⁶ Arch Patton, *Those Million-Dollar-A-Year Executives*, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s, 50, 54-55 (Fred K. Foulkes ed., 1991) (suggesting, among other changes, the use of retired executives).

³¹⁷ Millstein, *supra* note 12, at 1436-39.

³¹⁸ See part I.A.2(2).

³¹⁹ See *supra* text accompanying note 105.

³²⁰ See *supra* text accompanying note 106.

³²¹ Bok, *supra* note 12, at 98; Barris, *supra* note 12, at 77; Elson, *supra* note 11, at 979.

which these teams operate provides a playground for group-think. It is not unusual for chief executives to sit on one another's compensation committees in the capacity of outside directors. These CEOs may approve increases for friends because they expect the favor will be returned, or simply because the corporate environment in which they operate approves of lavish spending on top executives.³²²

The banking agencies do not appear to have embraced any other specific measures of reform of the process of setting compensation. Instead, they have focused on regulating the content of compensation plans. This is not meant to suggest that the banking agencies are exceeding their authority in this area. While Congress has provided some indication that it is wary of regulatory intervention into the content of compensation plans,³²³ Congress has invested the regulators with various means of doing just that.

Regulation of the content of compensation plans has the advantage of taking the decision-making function away from self-interested board members and placing it in the hands of the regulators. While this eliminates management self-interest from the decision-making process, it does not align decision-making with the interests of shareholders—the goal of the proposals for reform discussed above. Regulation of the content of compensation plans has the effect of aligning the decision-making process with the interests of the regulators. While the regulators may have some interests in common with shareholders, e.g., limiting cost of operations, the regulators may not share other interests, e.g., maximization of profits through risk-taking.

The risk of allowing regulatory interest to influence or limit compensation practices is that such intervention may undermine the ability of banks to compete with their non-bank rivals who are not subject to similar regulation. The best compensation practices evolve from innovative business acumen and decision-making that can give a company a competitive edge in attracting human capital.³²⁴ The banking agencies lack the expertise necessary to make complex compensation deci-

³²² Barris, *supra* note 12, at 76. Of course, some compensation committees are better than others. The National Association of Corporate Directors has issued useful guidelines on the role of compensation committees. Report of the NACD Blue Ribbon Commission on Executive Compensation: Guidelines for Corporate Directors, at 1–5 (Mar. 15, 1995).

³²³ Congress indicated that the safety and soundness standards set by the agencies "may not prescribe standards that set a specific level or range of compensation for directors, officers, or employees of insured depository institutions." 12 U.S.C. § 1831p–1(d)(1) (1996). See discussion *supra* part I.B.2.

³²⁴ See *supra* part IV.C.

sions in this arena. As a result, the agencies should be reluctant to remove this decision-making authority from the banks they regulate.³²⁵

The agencies and Congress could, however, take a more proactive approach toward reforming the process of making compensation decisions. Consideration could be given to proposals for reform that focus upon that process.³²⁶ For example, Congress could require, or the agencies could encourage, banks to compensate their outside directors, at least in part, in stock.³²⁷ Reform of the decision-making process could address safety and soundness issues³²⁸ without negatively impacting banks' competitiveness.

CONCLUSION

Congress and the appropriate federal banking agencies have a legitimate interest in financial institutions' compensation practices given the potential impact of such practices on banks' safety and soundness. This regulatory interest, however, must be balanced against the banks' need to attract, motivate and retain high quality employees.³²⁹

³²⁵ This should not be read to imply that the banking agencies should never limit the content of bank compensation plans. When the current financial condition of the bank is seriously troubled and unscrupulous bank executives decide to take what assets are left, regulatory intervention preventing such practices clearly is in order. Effective reform of the process of decision-making, however, should prevent bank executives from making and implementing take-the-money-and-run decisions.

³²⁶ One of the proposals for reform discussed *supra* is aimed toward the content of compensation plans, i.e., the proposal that tied executive compensation to share price and other performance indicators. This article does not suggest the application of this approach to bank compensation practices for three reasons. First, tying compensation to, for example, stock price has the disadvantage of focusing executive management's efforts on short term profitability rather than long term value of the company. Second, efforts to find performance indicators without the inherent flaws associated with the use of the stock price is particularly difficult in the case of financial institutions. See generally W. Donald Gough, *Strategic Executive Compensation in Financial Services*, in EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s, *supra* note 316, at 459-73. Finally, if tying executive compensation to share price, for example, is an effective means for compensation, then bank management should be led to that method of compensation as long as the decision-making process is not riddled with self-interest. Therefore, focus on the process seems at the heart of reform.

³²⁷ While members of the board of directors of national banks are currently required to own shares of their bank's stock, the amount of stock involved is not significant enough to align the directors' interests with that of shareholders. There is no requirement that directors receive stock as compensation.

³²⁸ If the process for making compensation decisions at a bank was faulty to begin with (i.e., infused with self-interested decision-makers), then reform of the process would likely yield different decisions (i.e., perhaps a lower annual salary for the CEO or perhaps a salary that is contingent on certain performance indicators).

³²⁹ By analogy, the government's legitimate interest in automobile safety and reducing traffic fatalities is not addressed by outlawing the automobile. The resolution of traffic safety issues,

Unfortunately, balancing these interests is a particularly difficult task when the regulatory interest is greatest, i.e., as a bank's financial condition deteriorates.³³⁰ A bank's need to attract, motivate and retain high quality employees arguably peaks when the bank is financially troubled, while employees and executives concurrently have the greatest incentive to seek employment elsewhere. As a practical matter, this paradox pits the agency's heightened scrutiny and instinct to intervene against the bank's need to maintain maximum flexibility during crisis management. In such an environment, it is unrealistic to believe that broad agency limitations upon compensation practices can be reconciled with the bank's pending needs.

Moreover, a healthy bank, faced with arbitrary or burdensome limitations upon its compensation practices (even if those limitations apply only in the event of insolvency), may find itself unable to compete for the quality leadership necessary to succeed or distinguish itself in this highly competitive industry. Yet clearly, the regulators' intent is not to threaten the long-term viability of healthy institutions. Also, the regulators do not intend to remove from the banking industry, as a means to achieve a competitive edge, the free market for human capital and its associated resources, such as talent, experience, training and innovation. For these reasons, the regulators must exercise caution in limiting compensation practices for both healthy and ailing banks.

From a systemic viewpoint, regulation of the content of compensation plans is most troubling because it puts regulators in the position of making pure business decisions for banks. The federal banking agencies, quite understandably, are ill-equipped to make these decisions. Compensation, particularly executive compensation, often depends upon trade-offs between assets the bank has at its disposal and incentives which a current or potential executive perceives as valuable. The potential variables include dissimilar items such as salary, bonus, deferred compensation, stock options, retirement, golden parachutes,

including, for example, national speed limits, automobile bumper standards, side impact protection, and airbags, involves a highly scrutinized, ever-evolving process of debate, legislation, and regulation contemplating the costs and benefits of certain measures. Arbitrary regulation of an industry, whether the issue be automobile safety or bank compensation practices, is most effective when tailored to solving a specific problem. Conversely, broad, sweeping "reform," implemented in the wake of a post-crisis frenzy, may create more problems than it solves.

³³⁰ The agencies have the powers discussed in part I regardless of the financial condition of the bank. *See supra* part I. The powers discussed in part II are added to their arsenal when the bank's condition is troubled. *See supra* part II. The FDIC has the added powers, as receiver, discussed in part III, when the bank is put into receivership. *See supra* part III. The FDIC's receivership powers, however, are not powers given to the FDIC in its regulatory role but rather they are granted to the FDIC as receiver.

life and health insurance, office perks, transportation and even vacation. Negotiating an individual's compensation package entails both parties' assets and desires regarding these and other variables. For example, an excellent joinder between a troubled financial institution and a talented executive might entail a conservative (if not Spartan) current compensation plan, with dramatic incentives (perceived as generous, if not outrageous) including bonuses, deferred compensation and stock options, contingent upon the bank's future success.³³¹ It is inimical to believe that the banking agencies are the proper arbiter of the wisdom of such a relationship.

The regulatory interest in compensation practices is addressed more appropriately by efforts to reform the bank's compensation decision-making process. This would absolve the regulators from deciding whether, for example, a severance package should compensate employees for up to one year versus two years of annual pay.³³² Yet it would permit the banking agencies to promulgate guidance regarding the processes undertaken by banks to determine compensation. More specifically, the agencies could craft requirements ensuring that the business people responsible for these important business decisions bear, in some formalized manner, the responsibility, risk and reward for those decisions.³³³

If federal banking regulation focused upon improving the decision-making process, such that decisions regarding compensation were made with the interests of the bank and its shareholders in mind, rather than the interests of incumbent management, safety and soundness issues could be addressed without negatively impacting a bank's competitive edge.

³³¹ For example, in 1980, Lee Iacocca accepted a compensation package from Chrysler under which he worked, for a time, for one-dollar-a-day, and eventually reaped a tremendous windfall (from 1981 to 1986, he made more than \$15,000,000 from Chrysler stock) when Chrysler sales rebounded. See, e.g., *Iacocca: I'm Probably Not Worth It*, SAN DIEGO UNION-TRIBUNE, Apr. 23, 1986, at A13. Consider also the \$10,500,000 bonus given to Michael Eisner following a period of spectacular financial success for Walt Disney after a number of disappointing years under prior leadership. FRANK & COOK, *supra* note 12, at 67.

³³² See *supra* note 314 and accompanying text.

³³³ A statutory or regulatory requirement that banks compensate their outside directors, at least in part, in stock, would represent a less intrusive and, perhaps, more effective means to address certain compensation abuses. See *supra* note 314 and accompanying text.