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Fourth Quarter
2007

Advocate
FOR INSTITUTIONAL INVESTORS
A Securities Fraud and Corporate Governance Quarterly

Wall Street, Heel Thyself: Put a Leash on Runaway Exec Pay!

By Tony Gelderman and Bruce W. Leppla

The 2007 bonus pool for the five largest investment banks totals $39 billion. Shareholders of securities firms lost over $200 billion in equity in 2007.

As we look back at 2007, we see historic meltdowns in the United States financial sector. The S&P Financial Index declined over 20% for the year and many of the largest investment banks lost nearly 50% of their market capitalization (see chart at right). The collapse of our financial sector has caused a major credit crisis and recessionary worries throughout the economy worldwide.

These declines in value, and the billions of dollars of associated investor losses, are not linked to classic Adam Smith notions of business cycle expansion and contraction, but rather are the direct consequence of the current "subprime loan" scandal — a completely "man-made" economic fiasco. This fiasco has been driven by a chain of greed — starting with the loan underwriters and their sales force that pushed inappropriate home loans on consumers, to the complicit appraisers who conjured up values to ensure that consumers could qualify for such loans, to the bankers who were willing to ignore underwriting standards to book such loans and earn commissions, ending with the investment bankers who packaged and sold the doomed loans to investors without disclosing the associated risks. In other words, the current wave of massive investor losses is not the result of a failed business model, or a paradigm shift in technology, or some other, natural economic force, but rather was caused by the market's gradual realization that Wall Street bankers have been knowingly and fraudulently selling into the market CDOs and similar securities backed by worthless or near worthless subprime loan collateral.

In total, the major investment banks have taken nearly $80 billion in subprime-related writedowns to date — with potentially more to come.

However, it will be *shareholders* who bear the brunt of the losses — not the Wall Street executives who facilitated the fiasco. Investment firms and public companies will continue to

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Wall Street's Self-Inflicted Subprime Woes*

	Subprime Writedowns *(in billions)*	2007 Change in Share Price	Lost Market Capital *(2007 – in billions)*
Citigroup	$22.1	-47%	$118.9
Merrill Lynch	24.5	-42%	32.3
UBS	18.4	-24%	27.2
Morgan Stanley	9.4	-35%	14.2
JPMorgan Chase	1.3	-10%	10.8
Bear Stearns	2.6	-46%	9.9
Lehman Brothers	1.5	-16%	6.3

*As of January, 2008

pay their top executives oversized bonuses. For example, a *Bloomberg* article recently estimated that the bonus pool at the five largest investment banks would total a record $39 billion for 2007 — a year in which the shareholders in the securities industry lost over $200 billion in equity. These firms include Merrill Lynch and Bear Stearns, both of which experienced huge losses in subprime related securities. To be sure, at least three high-profile firms have dismissed their chief executives but, with Charles Prince and Stanley O'Neal receiving some $40 million and $162 million in stock awards and pension benefits, respectively, on their departures, it can hardly be said that heads have rolled.

These breathtaking payouts underscore the need for reform in executive compensation in order to return accountability to corporate America. For example:

- O'Neal's payout at Merrill Lynch is only in the middle of the top 10 "golden goodbyes" for corporate CEOs, shown in the table on page 4. Incredibly, executives from at least 4 of these 10 firms departed because of mismanagement (Home Depot and Merrill), outright scandal (UnitedHealth), or bringing a company to the brink of bankruptcy (Conseco).

- More shocking — the top executives at 16 firms with potential subprime losses have contracts that entitle them to severance packages totaling $1 billion, or more than $60 million each, on average. This figure takes into account the decline in stock value seen so far and its impact on executive stock-based compensation.

- A *Forbes* article published in May 2007 concluded that the chief executives of America's 500 largest companies received a collective pay raise of 38% in 2006 alone even though the total return on the S&P 500 was only 15.8% in that same year. In dollar terms, the average CEO received a $15.2 million raise.

Unquestionably, companies have become increasingly more generous to executives, with outsized salary, options and severance packages. But, how did executive compensation become so untethered to performance? Bottom line — boards are to blame. Directors, who are supposed to be the stewards of shareholder interests, approve executive compensation packages. Shareholders, in contrast, have little or no opportunity to hold their boards responsible for executive compensation decisions.

Moreover, compensation experts suggest that the huge pay packages have done little to improve performance. The proliferation of stock-based compensation motivates executives to take enormous risks — or even to commit fraud — in the hope of enormous payoffs, knowing that if unsuccessful, the executive suffers no actual out-of-pocket harm when options simply expire. While this risk-taking behavior might be acceptable where positive outcomes cancel negative outcomes, a recent study of 950 companies in which 50% or more of CEO pay came from stock option grants concludes the contrary. During the eight-year period studied, only 6.8% of the companies produced appreciable gains for stockholders while 10.1% of the companies lost value because option-loaded CEOs are riveted on upside possibilities, with little concern for downside.

Even recently adopted SEC rules requiring additional disclosure of executive compensation at public companies have not restrained excessive compensation. While disclosure has improved under the new rules, the line items are carefully buried in proxy material and, as a practical matter, shareholders have no effective way of limiting compensation through the proxy process.

Perhaps nowhere is pay so disconnected from performance as on Wall Street, where executive compensation is especially astonishing in the face of enormous investor losses. For example:

- Bonus payouts to investment bankers in 2007 will average approximately $217,000 per person.

- The firms paying these bonuses and the individuals receiving the largest figures are those at the highest levels — the very people who failed to exercise due diligence in vetting the credit and underwriting standards and practices of subprime lenders in recent years.

- These same firms and individuals aggressively and knowingly sold high-risk investments to pension funds without fully disclosing the investments' inherent risks.

Top Ten Golden Goodbyes

Largest CEO Exit Packages

4 of 10 departed for mismanagement, scandal or bringing company to brink of bankruptcy

Company	CEO	Year	Est. Payout *in $ millions*
Exxon Mobil Corp.	Lee Raymond	2006	$ 351
Pfizer Inc.	Hank McKinnell	2006	213
Home Depot, Inc.	Robert Nardelli	2007	210
Gillette Co.	James Kilts	2005	165
Merrill Lynch & Co., Inc.	Stanley O'Neal	2007	162
UnitedHealth Group Inc.	William McGuire	2006	153
WellPoint Health Networks	Leonard Schaeffer	2005	137
SouthTrust Bank	Wallace Malone	2006	135
Morgan Stanley	Philip Purcell	2005	94
Conseco Inc.	Stephen Hilbert	2000	73

Against this backdrop, the effort to undermine shareholder rights and loosen corporate accountability measures has gained traction. In the past year, at least four high-profile quasi-public interest groups, funded by Wall Street investment banks or their lobbyists, published "studies" concluding that the U.S. financial markets are becoming less competitive than foreign markets because of overly restrictive regulation or excessive litigation. All four recommend similar "solutions" to this crisis, including liability caps for auditors, more lenient standards for outside directors, "clarification" of several elements of securities fraud to favor corporate defendants, and the possibility of requiring arbitration in securities litigations. One group even advocates jettisoning rules-based accounting in favor of "principles-based" accounting, where auditors would apply a sort of "sniff test" to a company's presentation of its financial results. Taken together, the recommendations — if adopted — could substantially weaken options for legal action when fraud occurs. At bottom, the recommendations only serve to further insulate corporate executives and directors from accountability.

While the subprime scandal continues to wipe out billions of dollars of shareholder value creating the most illiquid, distressed markets in years, the investment banking industry shamelessly takes care of itself. Now, as before, better oversight, governance and regulation remain the most important safeguards to keep our markets open, fair, and honest against those who would profit through exploitation.

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