# New Look for Employment Agreements as FDIC Seeks to Recover Compensation

*Why "Best Efforts" Clauses are No Longer Sufficient*

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OVERVIEW

In its March 15, 2011 Notice of Proposed Rulemaking, the FDIC confirmed it would pursue recovery from all individuals who are substantially responsible for the failed condition of a covered financial company, all compensation paid during the two-year period before the FDIC was appointed receiver. As a result, financial companies, and also their senior executive officers and directors, should proactively plan for the FDIC to seek recoupment of compensation in the event of receivership; changing how employment and retainer agreements are prepared is but one fundamental place to start.

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FULL ARTICLE

On March 15, 2011, the FDIC confirmed it would actively seek to recover all compensation paid to directors and senior executive officers of certain failed financial companies. In particular, the FDIC announced it will pursue recovery from all individuals who are substantially responsible for the failed condition of a covered financial company and will seek to recover all compensation paid to these individuals during the two-year period preceding the failure, i.e., two years from the time the FDIC was appointed receiver, or during an unlimited time period in the case of fraud.

As required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the FDIC must provide for the "orderly liquidation" of covered financial companies predominantly engaged in financial activities. The FDIC provided substantive guidance in its March 15 Notice of Proposed Rulemaking ("NPR"), which also addressed those instances when the FDIC will seek to pursue recovery of compensation paid to certain directors and officers (Section 380.7). Although the NPR applies only to covered financial companies (e.g., bank holding companies and financial holding companies), all other financial companies, including insured depository institutions, should heed the FDIC's prescient guidance.

**Individuals Substantially Responsible for Failed Conditions**

When the FDIC is appointed receiver of a covered financial company, to recover the compensation paid to an individual, the FDIC must demonstrate the individual is substantially responsible for the failed condition of the financial company. Significantly important is how this demonstration is made. Most notably, the FDIC confirmed it will *presume* substantial responsibility with respect to the following individuals: (1) Chairman of the Board of Directors; (2) Chief Executive Officer; (3) President; (4) Chief Financial Officer; and (5) any other individual who acts in any other similar role, regardless of title, if that person had responsibility for the strategic, policymaking, or company-wide operational decisions of the company.

The only exception to this presumption is for directors and senior executive officers who (i) were *retained for the purpose* of improving the financial condition of the covered financial company, and (ii) were retained during the two-year period prior to the FDIC being appointed receiver of the company. Although this presumption may be rebutted if the director or senior executive officer can clearly and convincingly demonstrate that she performed her duties with the requisite degree of skill and care required, such a showing requires time and resources, without guarantee of success. Moreover, there is no "line in the sand" to satisfy this showing; instead, an administrative proceeding will ensue whereby the individual must rely on legal precedent and industry best practices to make such a showing. Consequently, for newly hired directors and senior executive officers, it is critical that each be able to unambiguously demonstrate that he or she was retained for the purpose of improving the company's financial condition, should the company later be placed in receivership.

**Fitting the Exception: Employment Agreements and Retainer Agreements**

Demonstrating that an individual was hired for the purpose of improving the financial condition of a company can, and should, be made in that individual's employment agreement for senior executive officers or retainer agreement for directors. Specifically, to show this particular intent existed at the time of hire, these agreements should include a provision that expressly states the individual was retained for this particular purpose. While it is standard for employment and retainer agreements to include a generic description of the purpose for which the individual is being retained, these descriptions often exist in "form language" and will not be sufficient to avoid the FDIC's wide-reaching presumption. For instance, it is standard to include language that requires the individual to act in the "best interest" of the company and to perform all duties using his or her "best efforts." Going forward, although this form language will continue to be necessary, it will, by itself, be wholly inadequate to avoid the FDIC's presumption of substantial responsibility.

Additionally, the director or senior executive officer must also have been retained within two years prior to the FDIC being appointed receiver. Because no individual or organization, including the FDIC, can predict with precision when exactly a covered financial company will enter receivership, every employment or retainer agreement should explicitly provide for this particular purpose of improving the company's financial condition, regardless of the company's then-existing financial condition.

**Insured Depository Institutions**

Although the FDIC's proposed rule excludes insured depository institutions, such institutions should also consider including a similar provision in the agreements for their senior executive officers and directors. Notably, insured depository institution must have strong corporate governance standards in place, and part of satisfying this standard requires that insured depository institutions have measures in place to ensure that all incentive compensation arrangements for covered employees (not limited to senior executive officers) are appropriately balanced and do not jeopardize the safety and soundness of the institution. Deferring incentive compensation payments and requiring the repayment of incentive payments previously received ("clawback") are two ways to achieve this balance. Likewise, expressly including a provision in an employment or retainer agreement that the individual is being retained to improve the financial condition of the institution is equally consistent with, and furtherance of, this regulatory expectation.

**Going Forward**

Ultimately, in the aftermath of Dodd-Frank, the employment agreements and retainer agreements for senior executive officers and directors of all covered financial companies must take on a new look. Likewise, the employment agreements for senior executive officers at insured depository institutions should also continue to evolve. As a result, financial companies, and also their senior executive officers and directors, should proactively plan for the FDIC to seek recoupment of compensation in the event of receivership. Changing how employment and retainer agreements are prepared, so as to affirmatively demonstrate the individual was retained for improving the institution's overall financial condition, is but one fundamental place to start.

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