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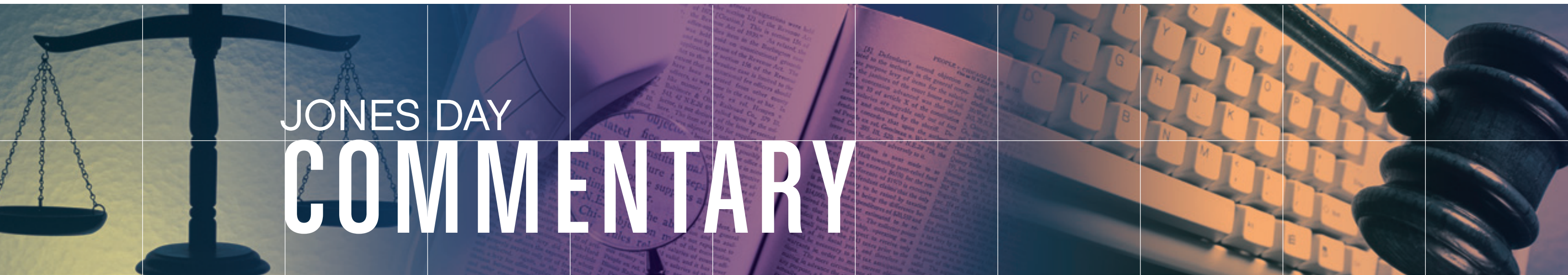

POSSIBLE CHALLENGES TO RETROACTIVE RESTRICTIONS ON EXECUTIVE COMPENSATION

- The Stimulus Bill, Section 7001, expands the executive-compensation restrictions of last fall's Emergency Economic Stabilization Act (§ 111). It requires the Treasury Secretary to apply the new restrictions retroactively, to all existing TARP recipients.

- In addition, the House has passed a bill that would impose a 90% surtax on bonuses granted to employees who earn more than $250,000 at companies that have received more than $5 billion in TARP funds (not counting repaid TARP funds). The tax would apply retroactively to any bonus received after December 31, 2008.

  - The Senate is considering a similar bill, which would impose an excise tax (35%) on both the TARP recipient and the bonus recipient, and apply if an institution held more than $100 million of TARP funds.

- Both contractual and constitutional challenges to the application of Section 7001 to existing TARP recipients are available.

- A suit for declaratory and injunctive relief could be brought now in the U.S. District Court for the District of Columbia.
- Or a financial institution could sue for damages in the Court of Federal Claims upon complying with the Secretary's new standards.
- The choice depends on an institution's priorities—trying to forestall the new standards or being compensated for the harm they cause.

- Similar legal challenges could be raised to a bonus tax. Additionally, a bonus tax could be challenged as an unconstitutional bill of attainder.

- **A contractual challenge to Section 7001 could be brought based on the terms of the Securities Purchase Agreement with the Treasury.** The theory, based on *United States v. Winstar*, 518 U.S. 839 (1996), would be that Congress has forced the Secretary to breach the Agreement by imposing additional restrictions and, correspondingly, that an institution would not be in breach in refusing to follow them.

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- *Theory*: In Sections 1.2(d) & 4.10 of the Agreement, institutions selling preferred stock and warrants to the Treasury agreed to abide by the executive-compensation restrictions in Section 111 plus all implementing regulations *as of the closing date*. An institution would argue that the Secretary thus agreed not to impose additional restrictions post-closing, and that in any event the new restrictions are not part of the Agreement and thus not binding.
- *Defense*: Section 5.3 of the Agreement, however, allows the Secretary to "unilaterally amend any provision . . . to the extent required to comply with any changes after the Signing Date in applicable federal statutes." If the Secretary tried to employ this, an institution would have two substantial arguments:
- Section 5.3 only allows unilateral amendments post-signing to conform to public and general laws, not those targeting TARP recipients; and
- Even if Section 5.3 generally allowed post-signing amendments based on statutes targeting TARP recipients, it does not regarding executive-compensation restrictions, given Sections 1.2(d) and 4.10.
- *Timing and Remedy*: An immediate suit would seek a declaratory judgment. Treasury would invoke sovereign immunity, but there are arguments for distinguishing the authority it would cite. A post-compliance suit would be for damages and more straightforward jurisdictionally.
  - Victory in a declaratory judgment action might enable an institution to disregard the new rules, by preventing the Secretary from suing for breach. Neither Section 111, nor Section 7001, nor the Agreement provides an enforcement mechanism, but Treasury and bank regulators likely could employ other regulatory means. Treasury presumably also would refuse to provide additional TARP funds.
  - Victory in an immediate suit also might cause the Secretary to give the broadest possible interpretation to Section 7001's exception for "any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009."
- *Related Claim*: An affected employee could seek a declaratory judgment (not damages) for tortious interference with contract. Treasury would invoke sovereign immunity, but a D.C. Circuit decision supports such an action. The contract regarding his bonus could not be so specific as to satisfy the exception.

- **An institution could challenge Section 7001 as an unconstitutional unilateral modification of obligations under a contract to which the Government is a party.**

  - Such a claim will depend on a court's willingness to apply against the Federal Government, via the Due Process or Takings Clauses, principles of the Contract Clause, which restricts States from impairing the obligation of contracts.
    - The Contract Clause has most force when a government alters its own contracts.
    - The Supreme Court repeatedly has suggested that some Contract Clause principles apply against the Federal Government but rarely has had occasion to act on the idea.
  - Such a claim also will depend on the contractual theory discussed above.

- **An institution and affected employee could challenge Section 7001 as unconstitutional restrictions on their property rights under the Takings and Due Process Clauses.**

  - The theory would be that Section 7001 impermissibly burdens an institution's property right to dispose of its funds as it sees fit, as well as affected employees' right to receive expected compensation for services rendered.
  - The general constitutional principle is that congressional abrogation of property rights—especially retroactively—raises serious constitutional issues. The strongest precedent is *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998), a 5-4 decision in which four justices relied on the Takings Clause and one on due process to strike down a statute that imposed a multi-million dollar liability on a former coal company to fund lifetime health-care benefits for persons it had employed thirty years before and to whom it had never promised such benefits.
  - The normal justifications by which courts uphold restrictions on property rights (such as minimum-wage

laws and rent control) do not apply here. Nor does Section 7001 redress fraud or some other harm to taxpayers by TARP recipients, especially given that the original executive-compensation restrictions addressed such concerns directly, as do provisions of the Agreement.
  - There would, of course, be counterarguments to a suit under this theory, and this is an area in which courts tend to look for ways to defer to governmental regulations and the law is fractured and unpredictable.

- **Similar legal challenges could be raised regarding a bonus tax.**

  - For the reasons discussed above, if Congress passed a law extinguishing existing contracts with TARP recipients, it would constitute a breach and violate the Due Process and Takings Clause. Surely Congress cannot accomplish the same result via a targeted tax that is the functional equivalent of prohibiting certain bonuses.
  - Although there is little case law on point, in an analogous situation, the Court held a tax to violate the First Amendment because it was enacted "with the plain purpose of penalizing the publishers and curtailing the circulation of a selected group of newspapers." *Grosjean v. Am. Press Co.*, 297 U.S. 233, 251 (1936).
  - The Due Process and Takings arguments would be aided by the bonus tax's narrow focus and retroactivity. As *Eastern Enterprise* shows, if Congress wishes to impair property rights by retroactively burdening a narrow class of persons, it needs some persuasive justification. Here, even though courts often defer to legislatures on tax issues, it is difficult to see what Congress's legitimate interest would be. As discussed above, issues surrounding executive compensation were known and addressed when the Government entered into the Securities Purchase Agreements.

- **In addition, a bonus tax might be challenged as an unconstitutional bill of attainder.**

  - The Constitution (Art. I, § 9) prohibits bills of attainder, which are laws that determine guilt and inflict punishment upon an identifiable group of individuals without the protections of a judicial trial.
  - Whether the legislature labels a narrow and punitive law as "civil" rather than criminal does not control whether it is a bill of attainder. *See Consol. Edison Co. v. Pataki*, 292 F.3d 338 (2d Cir. 2002) (holding to be a bill of attainder a statute barring a utility from passing onto consumers the cost of replacing certain defective steam generators and requiring the utility to reimburse any costs already recovered); *see also Navegar v. United States*, 192 F.3d 1050, 1068 n.11 (D.C. Cir. 1999).
  - Here, the argument would be that, even though the bonus tax is a "civil" law, it is an unconstitutional bill of attainder because it amounts to legislative imposition of a fine or forfeiture—especially a bonus tax as narrow and punitive as that passed by the House. In addition, Congress plainly is purporting to act in response to what it considers "wrong" behavior, and the Bill of Attainder Clause does not require that the conduct have allegedly violated any criminal law.

- **Regulatory Issues.**

  - Compensation issues are also important to bank regulators, who have become sensitive in this area, and who have broad examination and enforcement powers. Companies considering challenges to the compensation restrictions should evaluate their regulatory situation and possible regulatory reactions to a potential challenge.

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