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Roger Williams University School of Law

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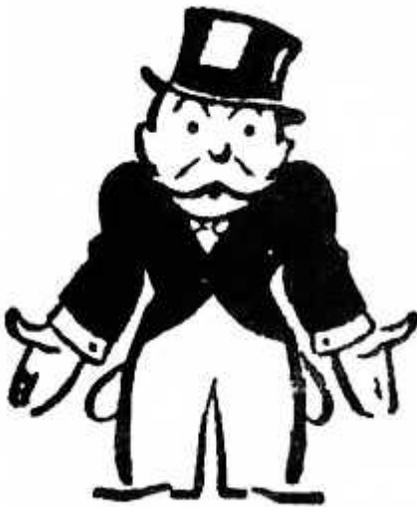
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# Newsroom

## Kropp on Executive Accountability

MSNBC speaks to Professor Steven Kropp about the lack of accountability for CEOs and other executives when their companies go bankrupt.

**From MSNBC:** ["CEOs rake in huge sums when their companies go bankrupt"](#) by Martha C. White



**Jan. 27, 2012:** When companies go bankrupt, the misery is shared among many: Bond holders are wiped out, retirees see their pensions and benefits vanish, and employees lose their jobs.

But some feel no pain at all: CEOs and other top executives of companies that go through Chapter 11 receive robust compensation in the form of salary, stock grants and other benefits.

In some cases, they earn even more money than they did before the filing, even while other stakeholders suffer. It's the most unlikely fast-track to a fat payout ever, and it goes on in spite of federal legislation meant to crack down on corporate honchos feasting while everyone else fights over crumbs.

It wasn't supposed to be like this. In the wake of corporate catastrophes such as Enron, Congress passed legislation aimed at preventing companies from paying retention bonuses to executives at firms going through Chapter 11.

"You can't pay someone for just staying at a bankrupt company," said Robert Jackson, an associate professor at Columbia Law School at Columbia University, and former advisory to senior Treasury officials

on executive compensation during the financial crisis. "But that's different from paying them from doing well at a bankrupt company," he said.

That distinction has become a loophole. Since the law allows performance-based incentives, huge executive payouts have morphed over the years to be little more than retention bonuses by another name, according to critics who say executives net outsized payouts even when they negotiate agreements that leave stakeholders out in the cold.

"There seems to be no sense of accountability at this level," said **Steven Kropp, a professor at Roger Williams University School of Law**. "In most of these cases, the unsecured creditors aren't being paid back in full, employees are being laid off, and in addition, they're finding their health insurance and pensions diminished." An investigation by The Wall Street Journal found that median compensation of CEOs at 21 companies that filed for bankruptcy was \$8.7 million, just \$400,000 less than the median compensation earned by CEOs at healthy companies.

Companies are required to go to court and argue their case for big bonuses with the bankruptcy judge, explaining why the CEO deserves the set level of compensation and what targets they must meet in order to earn their bonus. The problem is that often the bar is set so low that even lackluster performance will be measured as success.

"It's all fine and well to say you're going to pay people for performance, but the key is what kind of performance," Jackson said. "It's very hard for a judge to know if an earnings target is easy or hard to hit.

Are they just window dressings?" To make this determination, the court has to rely on evidence from the company's executives and lawyers, who may have an incentive to give themselves easy assignments.

Judges also have to rely on the input of compensation experts — also hired by the company — to know if the bonuses being proposed are appropriate for the industry and the task at hand, which also raises the prospect of manipulation.

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To keep companies from taking advantage of this, Jackson said, bankruptcy courts could have their own industry-specific experts to vet the numbers being proposed by people on the company payroll.

Critics of the current status quo say there are other legal ways to patch the ballooning-bonus loophole.

"You could simply amend the bankruptcy code to preclude a company in bankruptcy from paying bonuses in excess of prior salary to its existing executives," John Coffee, a professor at Columbia Law School, said via email. "Or you could limit the amount of any additional income in excess of their prior compensation from the firm to some reasonable percentage."

**Kropp suggests** using clawback provisions to cap executive compensation in the event of bankruptcy and funneling the recovered funds into employees' investment accounts. Even advocates of reforms like these, though, admit that they're a political no-go for lawmakers in today's contentious legislative environment.

The argument in favor of big bonuses, even when they come at the expense of employees, retirees and other unsecured creditors, is that successfully guiding a company through bankruptcy and emerging on the other side is a challenging, risky job, and most CEOs would bolt without the promise of millions in cash and stock for their trouble.

But research done by Ethan Bernstein, a Kauffman Foundation Fellow on leave from Harvard Law School, shows that CEOs of financially troubled companies quit or are ousted at the same rate whether or not they file for bankruptcy or muddle through with private restructuring.

For some, this raises the troubling possibility that Chapter 11 has become a back door for CEOs to grant themselves raises, especially in light of the fact that the Journal's research found CEOs at some troubled firms actually earned more after filing for Chapter 11.

"My belief is that CEOs and other senior executives can panic a board with the implied threat that they might desert the sinking ship if some formula is not found to give them extraordinary pay for their service in a crisis," Coffee said.

Pulling a teetering company back from the brink is hard, and it's an increasingly specialized job, which Bernstein said contributes to the high number — 37 percent — of CEOs brought on either during a bankruptcy reorganization or in the year leading up to it.

He said key stakeholders want a "bankruptcy guru," and they're willing to shell out enormous sums for the services of a CEO they think can pull the most money out of a troubled company. The catch is that this slate of decision-makers increasingly includes big creditors, negotiating with the kind of clout once limited to shareholders. What a creditor sees as the best return on its investment may very well be a bloodbath for the company's rank-and-file.

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