Economic “Stimulus” Legislation to Impose New Executive Compensation Restrictions

Applies to Existing and Future TARP Participants

SUMMARY
The final version of the American Recovery and Reinvestment Act of 2009, which was passed by the House earlier today and is expected to be passed by the Senate later tonight, includes extensive new restrictions on the compensation arrangements of financial institutions participating in the Troubled Asset Relief Program ("TARP"). The new legislation, which the President is expected to sign into law shortly, rewrites Section 111 of the Emergency Economic Stabilization Act of 2008 (“EESA”)¹ and directs the Treasury Department to establish standards and promulgate implementing regulations.

TREASURY TO ESTABLISH NEW STANDARDS
The new standards will codify many of the executive compensation guidelines for TARP recipients announced by the Treasury Department on February 4, 2009, impose additional restrictions and apply to all existing and future TARP recipients. It is not clear whether the standards will be immediately effective or will only be effective after regulations are issued.

Under the legislation, the standards are required to include the restrictions and other provisions summarized below, which include a variety of terms the meaning and scope of which have not been made clear.

- **Financial Institutions Affected.** The restrictions apply to all entities that have received or will receive financial assistance under the TARP during the period the TARP recipient has an obligation outstanding that arises from TARP financial assistance. However, the restrictions cease to apply if the Federal Government only holds warrants to purchase common stock of the TARP recipient.

- **Employees Affected.** Many of the restrictions extend beyond the TARP recipient’s CEO, CFO and three next most highly-compensated executive officers (the “senior executive officers”) and...
apply to other highly-compensated employees as well. It does not appear that other highly-compensated employees need to be officers of the TARP recipient, nor do any provisions specify how to identify such highly-compensated employees (for example, whether based on current or prior year compensation, whether a potential highly-compensated employee could drop off the prohibited group because of the bonus limit and how compensation would be defined for this purpose.

- **Prohibition on Bonuses, Retention Awards, and Other Incentive Compensation.** During the TARP restricted period, a TARP recipient may not pay (or accrue) any "bonus, retention award or incentive compensation" to a group of employees that depends on the amount of TARP assistance the financial institution has received. The restricted group ranges from the most highly-compensated employee for institutions with less than $25 million of TARP assistance to the five senior executive officers and at least the next 20 most highly paid employees for institutions with more than $500 million of TARP assistance.

The prohibition does not apply to (1) any bonus required to be paid pursuant to written employment contracts executed on or before February 11, 2009 ("as such valid employment contracts are determined by" Treasury) or (2) payment of “long-term” restricted stock that has a value not exceeding 1/3 of the employee’s total annual compensation, that does not fully vest during the TARP period, and that is subject to such other terms and conditions as Treasury determines are in the public interest. The legislation does not make clear how the term “fully vests” is to be interpreted and whether other forms of equity compensation and long-term incentives could qualify for the restricted stock exception. This prohibition also does not appear to apply to salary.

- **Prohibition on Golden Parachutes.** No golden parachute payments may be made to the five senior executive officers or the next five most highly-compensated employees during the TARP restricted period. Unlike the current regulations that apply to companies in the TARP Capital Purchase Program, “golden parachute” is broadly defined to include “any payment. . . for departure from a company for any reason, except for payments for services performed or benefits accrued”.

- **Expanded Clawback.** An expanded clawback applies to any bonus, retention award or incentive compensation paid to the five senior executive officers or the next 20 most highly-compensated employees based on “statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate”.

- **No Incentives that Encourage Unnecessary and Excessive Risks.** Compensation may not include incentives for the five senior executive officers to take unnecessary and excessive risks that threaten the value of such recipient.

- **Prohibition on Compensation Plans that Would Encourage Manipulation of Earnings.** Compensation plans may not encourage the manipulation of reported earnings to enhance compensation.

- **Independent Board Compensation Committee Review.** Each TARP recipient must establish a Board Compensation Committee comprised entirely of independent directors to review its compensation plans. This Board Compensation Committee must meet at least semiannually to assess any risks posed to the TARP recipient by its employee compensation plans. In private companies that receive or have received TARP assistance not exceeding $25 million, the board of directors will handle the duties of the Board Compensation Committee.

**OTHER NEW RESTRICTIONS AND PROVISIONS**

In addition to requiring Treasury to establish new standards as described above, the legislation includes the following restrictions and other provisions:

- **Early Repayment Explicitly Permitted.** TARP recipients are permitted (subject to Treasury’s consultation with the appropriate Federal banking agency, if any) to repay any assistance
previously received without regard to any waiting periods and without regard to whether the financial institution has replaced the funds with funds from any other source. Upon repayment of assistance, Treasury is to liquidate warrants associated with the assistance at the current market price and the financial institution will no longer be subject to any of the TARP compensation restrictions.

• **Retroactive Review of 2008 and Early 2009 Bonuses.** Treasury must retroactively review bonuses, retention awards and other compensation paid to the senior executive officers and the next 20 most highly-compensated employees of each TARP recipient before the date of enactment of the new legislation. The review is to determine whether such compensation is inconsistent with the purposes of the new legislation or the TARP or is otherwise contrary to the public interest and, if so, Treasury must seek reimbursement from the TARP recipient and individual employee with respect to such compensation or bonuses.

• **Annual Say on Pay Vote.** At each annual or other meeting of shareholders during the TARP period, TARP recipients must allow a separate nonbinding “say on pay” shareholder vote to approve executives’ compensation. The legislation requires the SEC to issue any final rules and regulations required by the “say on pay” provision within one year after enactment. It is not clear if this requirement will apply to upcoming annual proxies or only after regulations have been issued.

• **Policy on Luxury Expenditures.** Boards of directors of TARP recipients must adopt company-wide policies on excessive or luxury expenditures (as identified by Treasury), including excessive spending on transportation (including aviation) services, entertainment, office and facility renovations, and other events or activities that are not “reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course” of the TARP recipient’s business operations.

• **Required Certification by CEO and CFO.** The CEO and CFO of each TARP recipient must provide written certification of compliance with Section 111 of EESA. Public companies will provide the certification to the SEC together with their annual filings, and private companies will provide the certification to Treasury.

• **$500,000 Tax Deduction Cap.** The legislation provides that, during the TARP period, each TARP recipient will be subject to the provisions of section 162(m)(5) of the Internal Revenue Code, “as applicable”. Section 162(m)(5), recently enacted by EESA, imposes a $500,000 cap on deductible compensation for financial institutions that sell more than $300 million of assets through their participation in the TARP auction purchase program.²

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ENDNOTES


² For more information about this provision, see our memorandum entitled “Financial Bailout Legislation Restricts Executive Compensation”, dated October 7, 2008, pages 6-7.
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