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Client Alert

Economic Crisis Response Group

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Executive Compensation

Employee Benefits

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Financial Services

Stimulus Package Imposes Additional Executive Compensation Restrictions for TARP Recipients

On February 17, 2009, President Obama signed the stimulus bill formally titled the American Recovery and Reinvestment Act of 2009 ("ARRA"). ARRA includes new executive compensation restrictions that apply to institutions that have received or will receive financial assistance under the Troubled Assets Relief Program ("TARP"). TARP is the designation for the overall program under which the U.S. Treasury Department ("Treasury") originally was to acquire billions of dollars in troubled assets currently authorized by the Emergency Economic Stabilization Act of 2008, which was passed on October 3, 2008 ("EESA"). The Treasury abandoned its original plan to buy troubled assets from financial institutions and used TARP money to make direct equity investments in financial institutions.

Section 7001 of Division B (Title VII) of ARRA amends and restates in its entirety the provisions dealing with executive compensation in EESA. EESA provided specific restrictions on executive compensation for "senior executive officers" ("SEO") of financial institutions receiving certain levels of assistance. For this purpose, an SEO is generally a named executive officer as determined annually under the proxy statement rules. On October 15, 2008 and January 16, 2009 the Treasury released interim rules interpreting the executive compensation provisions in EESA. On February 4, 2009, the Treasury issued a new set of guidelines on executive pay for financial institutions receiving government assistance under TARP. It is not clear whether the new rules supplement or supersede prior Treasury rules or guidelines previously issued.

ARRA modifies the executive compensation rules originally enacted by EESA and codifies aspects of the interim guidance provided by the Treasury. Unlike EESA and prior guidance, ARRA generally makes no distinction between institutions based on the level of assistance received under TARP; however, as noted below in "Limits on Incentive Compensation," certain incentive compensation limits apply to a different number of executives depending on the level of assistance received. Unless otherwise noted below, the limitations on executive compensation appear to apply retroactively to all TARP recipients. We expect that the Treasury will release much needed guidance clarifying the interpretation and application of these rules.

Limitations on Executive Compensation

ARRA requires the Treasury to force TARP recipients to comply with "appropriate standards" for executive compensation and corporate governance including the following executive compensation limitations. These rules apply during the period in which any obligation arising from financial assistance under TARP remains outstanding.[1]

- **Limitations on Incentives Encouraging Risk.** ARRA requires TARP recipients to limit compensation arrangements that provide incentives for SEOs of the TARP recipient to take unnecessary and excessive risks that threaten the value of the TARP recipient.
- **Bonus Clawback Provisions.** A TARP recipient must have in place a provision to claw back bonuses or other incentive compensation payments from the SEOs and the next twenty highly compensated employees if statements of earnings, revenues, gains or other criteria on which the payment was based are later found to be materially inaccurate.
- **Limitation on Incentive Compensation**. ARRA prohibits paying any bonus, retention or incentive compensation to certain executives of TARP recipients, other than long-term restricted stock that does not vest during the period the financial assistance remains outstanding and that is not greater than one-third of the executive's annual compensation. This limitation applies to a different number of executives based upon the amount of financial assistance the TARP recipient received under TARP.[2] This prohibition does not apply to bonus payments required to be made pursuant to employment contracts executed on or before February 11, 2009.
- **Golden Parachutes and Severance Payments.** ARRA prohibits payment by a TARP recipient of any "golden parachute" to SEOs and to the next five most highly compensated employees. For purposes of ARRA, a "golden parachute" is any payment for a departure from a company for any reason, except for payments for services performed or benefits accrued.

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1 The period in which an obligation arising from financial assistance under TARP remains outstanding does not include any period during which the federal government only holds warrants to purchase common stock of the TARP recipient.

2 If a financial institution receives less than $25 million the limitation will only apply to their most highly compensated employee; if a financial institution receives at least $25 million but less than $250 million, the prohibition applies to the five most highly compensated employees; if a financial institution receives at least $250 million but less than $500 million, the prohibition applies to the five senior executives officers and the ten next most highly compensated employees; if a financial institution receives $500 million or more of TARP financial assistance, the prohibition applies to the five senior executives officers and the twenty next most highly compensated employees. ARRA specifies that the number of executives impacted could be higher if the Secretary of the Treasury ("Secretary") determines it is in the public interest for all institutions receiving $25 million or more in financial assistance.

- **Plans that Encourage Earning Manipulation.** ARRA forbids a TARP recipient from having a compensation plan that would encourage manipulation of the reported earnings to enhance compensation for any of its employees.

Board Compensation Committee

ARRA requires that all TARP recipients have a board compensation committee, comprised entirely of independent directors that meet at least semiannually to discuss and evaluate the risk posed on the TARP recipient by its employee compensation plans. A company that receive $25,000,000 or less of financial assistance under TARP and is not registered under the Securities and Exchange Act of 1934 is to fulfill this requirement with its board of directors instead of forming a separate board compensation committee.

Luxury Expenditures

The board of directors of each TARP recipient must adopt policies regarding excessive or luxury expenditures. ARRA authorizes the Secretary to identify luxury expenditures, but specifically notes that excessive or luxury expenditures may include excessive payments on aviation or other transportation services, entertainment, events, office and facilities renovations and other activities that are "not reasonable expenditures." It does not specify what the policy must be.

Executive Compensation Disclosure and Say on Pay Shareholder Resolution.

ARRA requires that a company receiving TARP assistance must permit a separate nonbinding shareholder vote to approve the compensation of the executives who are required to be disclosed pursuant to the compensation disclosure rules of the Securities and Exchange Commission. ARRA specifically provides that the shareholder vote will not be binding or overrule any decisions by the board of directors, will not create any additional fiduciary duties on behalf of the board and will not limit the ability of the company's shareholders to make proposals for inclusion in proxy materials related to executive compensation.

Review of Prior Payments to Executives

ARRA directs the Secretary to review bonuses, retention awards and other compensation paid to the SEOs along with the next twenty most highly compensated employees of each entity receiving TARP assistance prior to enactment of ARRA. If the Secretary determines that any such payments were "inconsistent with the purpose" of TARP or "otherwise contrary to public interest," the Secretary will negotiate with the entity and the executive appropriate reimbursement to the federal government.

Certification of Compliance

The chief executive officer and the chief financial officer of each TARP recipient must provide written certification that their company has complied with the executive compensation provisions of ARRA. A public company is to make such certification in their annual proxy disclosures filed with the Securities and Exchange Commission, while a non-publicly traded company will provide such written certification to the Secretary.

For more analysis on how TARP restricts executive compensation, please see our recent Client Alerts available on our website at http://www.proskauer.com/news_publications/client_alerts/content/2009_02_09 and http://www.proskauer.com/news_publications/client_alerts/content/2008_10_13_b.

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets, issues concerning investments in financial services companies, complex financial instruments and transactions, including structured finance products, as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

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