Stimulus Package Extends and Enhances TARP Restrictions on Executive Compensation

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the "Act") that was passed by Congress on February 13, 2009. The Act is the latest piece of legislation aimed at providing financial assistance to distressed financial institutions under the Emergency Economic Stablization Act of 2008 ("EESA"), which established the Troubled Asset Relief Program ("TARP").

Under EESA, as a condition of receiving TARP funds, financial institutions had to agree that during the period in which TARP funds were held by such institutions (the "TARP Period"), they would comply with what now appear to be relatively modest limitations on executive compensation, including (i) limits on compensation arrangements that encouraged excess risk-taking, (ii) "clawback" provisions for bonuses paid to senior executives, (iii) limits on "golden parachute" and severance payments to certain executive officers, and (iv) limits on the amount a TARP recipient could deduct with respect to compensation paid to certain senior executive officers. The Act dramatically broadens many of these requirements and imposes new limits on executive compensation paid by recipients of TARP funds ("TARP Recipients"). Significantly, these new requirements apply to all TARP Recipients, **even those that received funds prior to the enactment of the Act**. Notably, the Act does ease the ability of TARP Recipients to repay TARP funds, and thus terminate the application of the Act's executive compensation rules.

Extension of Original TARP Restrictions

Building on the original provisions included in TARP, the Act requires TARP Recipients to implement and comply with the following executive compensation and corporate governance standards during the TARP Period:

Limits on Incentives Encouraging Risk. The Act does not change the original TARP provisions regarding limitations on excessive risk-inducing compensation arrangements. Accordingly, TARP Recipients are still required to limit compensation arrangements that provide incentives for "Senior Executive Officers" to take unnecessary and excessive risks that threaten the value of the TARP Recipient. A "Senior Executive Officer" is defined as one of the five highest paid executives whose compensation is required to be disclosed under the Securities Exchange Act of 1934 (or, for non-public companies, comparable employees).

Bonus "Clawback" Provisions. The Act expands the reach of TARP's original bonus "clawback" provisions. While TARP originally required TARP Recipients to implement "clawback" measures for the recovery of any bonus, retention award or other incentive compensation paid to a Senior Executive Officer based on financial criteria subsequently found to be materially inaccurate, the Act expands this requirement so that it also applies to any of the next 20 highest compensated employees of a TARP Recipient.

Golden Parachutes and Severance Payments. Similarly, the Act significantly expands the provisions of TARP that prohibit a TARP Recipient from making any "golden parachute" payments. Under the Act, TARP Recipients are prohibited from making *any* severance payments to any Senior Executive Officer or any of the next five highest compensated employees.

Deduction Limit. It is worthwhile to note that the Act retains the $500,000 annual limit on deductible compensation paid to Senior Executive Officers of TARP Recipients during the TARP Period.

New Provisions Imposed by the Act

In addition to expanding many of the original TARP limitations, the Act imposes several new limitations:

Incentive Compensation. In the most dramatic new limitation imposed by the Act, TARP Recipients are now generally prohibited from paying or accruing ***any*** bonus, retention award or incentive compensation to specified employees. The prohibition applies differently to various TARP Recipients, based on the amount of the TARP financial assistance received. If the financial assistance received is:

- Less than $25 million, then the prohibition applies only to the most highly compensated employee;
- At least $25 million but less than $250 million, then the prohibition generally applies to the Senior Executive Officers;
- At least $250 million but less than $500 million, then the prohibition applies to the Senior Executive Officers and the next ten highest compensated employees; or
- At least $500 million or more, then the prohibition applies to the Senior Executive Officers and the next 20 highest compensated employees.

The Act further provides that if the Secretary of the Treasury determines it is in the "public interest," the group of executives subject to this limitation may be expanded.

This prohibition does not apply to the payment or accrual of long-term restricted stock that (i) does not fully vest during the TARP Period, (ii) that has a value not greater than one-third of the total amount of the executive's annual compensation, and (iii) that is subject to such other terms and conditions as the Secretary of the Treasury may determine are in the public interest. Moreover, this prohibition does not apply to "bonus" payments required to be paid pursuant to a written employment contract executed on or before February 11, 2009. The statutory language of the grandfathering provision, however, refers only to "bonuses," and as a result, it is unclear whether the grandfathering applies to other incentive compensation.

Luxury Spending. During the TARP Period, each TARP Recipient must adopt a company-wide policy regarding excessive or luxury expenditures. The Act charges the Secretary of the Treasury with identifying such luxury expenditures, but specifically notes that such expenditures may relate to:

- Aviation or other transportation services;
- Entertainment or similar events;
- Office and facility renovations; or
- Other activities that are not (i) reasonable expenditures for staff development, (ii) reasonable performance incentives, or (iii) other similar measures conducted in the normal course of business of the TARP Recipient.

"Say on Pay." During the TARP Period, each TARP Recipient must permit a separate nonbinding shareholder vote to approve the compensation of the "named executive officers" (i.e., the executives who are required to be disclosed pursuant to the proxy disclosure rules). The Act specifically provides that the shareholder vote will not (i) be binding or overrule any decision by the board of directors, (ii) create any additional fiduciary duties on behalf of the board of

directors, or (iii) limit the ability of the TARP Recipient's shareholders to make proposals for inclusion in proxy materials related to executive compensation. The Securities and Exchange Commission is expected to issue any required final rules and regulations related to this requirement no later than one year after the date of the enactment of the Act. In this regard, the Securities and Exchange Commission issued preliminary guidance on February 24, 2009 explaining that (i) the requirement for a shareholder vote on executive compensation is only necessary for annual shareholder meetings for which directors will be elected; (ii) a smaller reporting company that is subject to the Act's "say-on-pay" requirements, but that is otherwise exempt from the compensation discussion and analysis filing, will not have to provide a compensation discussion and analysis disclosure; and (iii) companies facing special circumstances that would like to request acceleration of the ten-day review period (i.e., the period in which proxy filings are subject to governmental review prior to distribution to shareholders) should contact the office that reviews their filings to discuss the special circumstances.

Compensation Committee. During the TARP Period, TARP Recipients must establish a board compensation committee comprised entirely of independent directors to meet at least semiannually to discuss and evaluate the risk posed to the TARP Recipient by its employee compensation plans. A company that receives $25 million or less of TARP assistance and that is not subject to the reporting requirements of the Securities Exchange Act of 1934 is permitted to fulfill this requirement with its full board of directors instead of forming a separate committee.

Compliance Certification. During the TARP Period, each TARP Recipient's chief executive officer and chief financial officer must provide a written certification of the TARP Recipient's compliance with the executive compensation provisions of the Act. For public companies, this certification will be contained in the annual filings required under the applicable securities laws, and for private companies, this certification will be provided directly to the Secretary of the Treasury.

Prohibition on Plans Encouraging Earnings Manipulation. The Act forbids the use of any compensation plan that would encourage manipulation of the reported earnings of the TARP Recipient to enhance the compensation of any of its employees. Because of the vague language of this provision, it is uncertain how this restriction will be applied. For example, there is no specific guidance as to the manner in which a TARP Recipient can avoid "encouraging" manipulation of reported earnings, and it is unclear whether the term "any compensation plan" applies beyond incentive-based arrangements.

Prior Payments. The Act instructs the Secretary of the Treasury to review bonuses, retention awards and other compensation paid to the Senior Executive Officers along with the next 20 highest compensated employees of each TARP Recipient prior to enactment of the Act. If the Secretary of the Treasury determines that such payments were inconsistent with the purpose of TARP or were otherwise contrary to the public interest, the Secretary of the Treasury is authorized to negotiate with the TARP Recipient and the affected employees, and to cause appropriate reimbursements to be made to the federal government. Notably, the Secretary of the Treasury is not given the power to "clawback" these bonus payments.

Removing the Millstone

The Act substantially loosens the conditions applicable to the repayment of TARP funds. Specifically, the Act permits a TARP Recipient to repay any TARP financial assistance, without regard to any applicable waiting period and without regard to whether the TARP Recipient has replaced such funds from any other source. Upon repayment of the financial assistance, the Secretary of the Treasury will liquidate the warrants associated with such assistance at the current market price and the TARP Recipient will cease to be subject to any of the TARP compensation restrictions.

Audit and Investigations

The enabling legislation creates a new Special Inspector General for the TARP program ("SIGTARP").

Neil Barofsky, formerly a federal prosecutor in the Southern District of New York, was sworn in as SIGTARP in December 2008. Barofsky has recently signaled that, in partnership with the United States Securities & Exchange Commission, the Federal Bureau of Investigation and the New York State Attorney General's Office, his office will closely audit and investigate TARP fund recipients for compliance with the executive compensation requirements, as well as with related corporate governance, reporting and certification provisions. Barofsky has also announced that his office will conduct audits and investigations to uncover possible misuse of TARP funds -- including possible circumvention of executive compensation restrictions -- and misstatements or other improper conduct in the procurement of TARP funds. SIGTARP has issued detailed audit letters to TARP recipients requiring narrative responses on these topics and certification to the accuracy of the responses.

The Executive Compensation Group counsels clients on a full spectrum of compensation issues, communicating complex and technical legal concepts in a practical, business-oriented fashion. For more information, please feel free to contact any member of the Executive Compensation Group, including:

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