



CLIENT MEMORANDUM

American Recovery and Reinvestment Act of 2009: Restrictions on Employee Compensation Arrangements of TARP Recipients

February 19, 2009

OVERVIEW

The American Recovery and Reinvestment Act of 2009 (the “Act”) was signed into law on February 17, 2009 and has significantly expanded the restrictions on executive compensation and severance arrangements at public and private institutions that receive financial assistance under the Troubled Asset Relief Program (“TARP”). These restrictions are imposed both on institutions that have already received assistance under TARP and on institutions that receive TARP assistance in the future (collectively, “TARP recipients”). In addition, as discussed further below, the Act requires the Secretary of the U.S. Treasury (“Treasury”) to review compensation paid by TARP recipients prior to the enactment of the law and, if Treasury determines that any such payments were inconsistent with the purposes of the Act or TARP or otherwise contrary to public interest, to negotiate with the TARP recipient and the employees who received such compensation for appropriate reimbursement.

The Act appears to subject all TARP recipients to the general provisions of the Act immediately upon enactment, but instructs Treasury to issue regulations to implement these provisions, without, generally, imposing any deadlines by which the regulations must be issued. This raises a number of critical questions that will need to be addressed by Treasury quickly, not the least of which is what TARP recipients can and should be doing now, in advance of the issuance of these regulations (e.g., whether they can pay bonuses in respect of 2008 and whether they should include “say-on-pay” proposals in their 2009 proxy statements).

Each of these provisions will apply to a TARP recipient for so long as any obligation arising from financial assistance provided under TARP remains outstanding (excluding periods during which the U.S. Government only holds warrants on common stock of the TARP recipient). The only way a TARP recipient can cease being subject to these restrictions on employee compensation is, generally, by repaying all

financial assistance previously received under TARP (although it does not appear that repaying the government would exempt an employer from compliance with the new rules for periods while an institution was a TARP recipient). In this regard, the Act specifically allows TARP recipients to repay TARP assistance at any time, subject to consultation with the applicable banking regulatory agency. (Under the standard form documents used in Treasury's Capital Purchase Program ("CPP"), TARP recipients are permitted to redeem the preferred shares issued to Treasury during the first three years after issuance only from cash proceeds received from qualifying equity offerings of any Tier 1 perpetual preferred or common stock.) In addition, if the financial assistance is repaid, Treasury must liquidate any warrants it holds in the institution at the then current market price.

The employee compensation provisions discussed in this memorandum were added to the Act on the date it passed both houses of Congress and replaced more flexible guidelines proposed by the Obama administration. As a result, the Act does not include the Obama administration's proposed cap limiting total compensation of any senior executive officer to \$500,000 (plus restricted stock that could not be sold until TARP financial assistance had been repaid and replaced with new capital). This means that there is no stated limit in the Act on the amount of annual base salary that could be paid to any employee of a TARP recipient, but there are significant limitations on the amount and form of bonuses that can be paid.

These new restrictions generally apply to compensation payable to – at a minimum – TARP recipients' "senior executive officers," which term is defined as the top five most highly paid executives of a public entity whose compensation is required to be disclosed under applicable securities laws (or, for non-public entities, whose compensation would be disclosed, if the TARP recipient were subject to such laws). However, many of the restrictions also cover between five and twenty additional "most highly compensated employees," depending upon the level of financial assistance provided to the institution under TARP. The use of the term "employees" rather than

"executives" or "officers" suggests that every single employee, whether or not a policymaker at the institution, and including those paid on a commission or bonus basis, could be considered for purposes of determining to whom these restrictions apply.

STANDARDS FOR EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

Each TARP recipient must satisfy certain "standards for executive compensation and corporate governance" to be established by Treasury. These standards will include the following:

- **Bonuses Limited to One-Third of Total Compensation; All Bonuses Payable in Restricted Stock.** TARP recipients cannot pay or accrue any bonus, retention or incentive compensation to certain employees, unless the compensation is payable solely in "long-term restricted stock" that has a "value" no greater than one-third of the employee's "total amount of annual compensation". This restricted stock may not "fully vest" until TARP obligations are repaid (excluding the U.S. Government's warrants on common stock of the TARP recipient), and must have such other terms and conditions, if any, as Treasury determines are "in the public interest." (None of the terms referenced in this discussion are defined in the Act.) The employees who are subject to this restriction on bonuses will vary depending on the amount of financial assistance the TARP recipient has received, and are as follows:
 - Only the most highly compensated employee of any TARP recipient that has received less than \$25 million in financial assistance (i.e. senior executive officers are not specifically covered);
 - At least the five most highly compensated employees of any TARP recipient that has received at least \$25 million but less than \$250 million in financial assistance;

- All senior executive officers and at least the ten most highly compensated employees of any TARP recipient that has received at least \$250 million but less than \$500 million in financial assistance;
- All senior executive officers and at least the twenty most highly compensated employees of any TARP recipient that has received \$500 million or more in financial assistance.
- For all TARP recipients that have received \$25 million or more of financial assistance, Treasury may expand the list of covered employees if it would be "in the public interest."
- There is an exception for the payment of bonuses required to be paid pursuant to a valid written employment contract executed on or before February 11, 2009, but the validity of any such agreement is to be determined by Treasury.
- **No Severance Payments to "Top 10".** TARP recipients will be prohibited from making any severance or other payment for departure to any senior executive officer or any of the TARP recipient's next five most highly-compensated employees, apparently even if these employees are parties to existing agreements containing severance protections. The only exceptions to this rule are "payments for services performed or benefits accrued." This concept is not defined, but would appear to allow payments related to bonuses, pensions and deferred compensation that are already earned and vested at the time of departure. Treasury's original rules under the CPP only prohibited severance-related payments to a TARP recipient's senior executive officers that exceeded three times the employee's "base amount" (generally, the employee's average annual taxable income over the prior five years).
- **Clawback on Bonuses Paid to "Top 25" based on Materially Inaccurate Financial Statements.** TARP recipients will be required to comply with Treasury standards providing for the recovery of any bonus, retention or incentive compensation that has been paid based on "statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate." This provision would apply to any senior executive officer and any of the next twenty most highly-compensated employees of the TARP recipients. There is no exception to this claw-back requirement (i.e., there is no requirement that the employees subject to this clawback provision be responsible for the inaccuracy). This provision is similar to the CPP requirement, but that rule generally only applies to senior executive officers.
- **Prohibition on Compensation Plans for Any Employee that Encourage Manipulation of Reported Earnings.** TARP recipients will be prohibited from creating any compensation plans "that would encourage the manipulation of the reported earnings of any TARP recipient to enhance the compensation of any of its employees." The Act does not provide any detail on how this standard is to be defined.
- **Exclude Incentives to take Unnecessary and Excessive Risks.** TARP recipients will be required to comply with Treasury standards designed to exclude incentives for its senior executive officers to take "unnecessary and excessive risks that threaten the value" of the TARP recipient. The Act does not contain any specifics regarding these standards, nor the definition of what constitutes "unnecessary and excessive risks." As Treasury

guidance under CPP already required a TARP recipient's compensation committee to periodically evaluate compensation arrangements to ensure that they do not encourage excessive risk, it may be that this provision does not represent a substantial expansion of current requirements.

- **Independent Compensation Committee Mandates.** Most TARP recipients must establish a "Board Compensation Committee," comprised entirely of "independent directors" (term not defined), which meets at least semiannually to "evaluate employee compensation plans in light of any assessment of risk posed to the TARP recipient from such plans." Any TARP recipient without registered common or preferred stock that has received \$25 million or less in financial assistance is to have its board of directors perform this evaluation. However, public companies generally already have compensation committees, making this requirement likely redundant with current practices.
- **\$500,000 Cap on Compensation Deductions.** All TARP recipients will be subject to Internal Revenue Code Section 162(m)(5) (which was enacted in 2008 to cap at \$500,000 the amount of compensation that certain TARP auction participants could deduct for each of its chief executive officer, chief financial officer and three other most highly compensated employees). Treasury already had required all CPP participants to forego these deductions, so this provision does not represent a meaningful change from current practice under TARP.
- **Certification of Compliance.** The chief executive officer and the chief financial officer (or equivalents thereof) of the TARP recipient must provide written certification of compliance with all of the above standards, either to the SEC with its annual

securities filings (for public institutions) or to Treasury (for non-public institutions, presumably also on an annual basis).

ADDITIONAL ACTIONS TO BE TAKEN BY TREASURY AND TARP RECIPIENT

In addition to the restrictions outlined above, TARP recipients will also be subject to the following:

- **Treasury Review of Prior Payments and Negotiation for Reimbursement.** Treasury is required to review bonuses, retention awards and other compensation paid to the senior executive officers and the next twenty most highly-compensated employees of each institution receiving financial assistance before February 17, 2009 (i.e., the date of enactment of the Act) in order to determine if any such payments made were "inconsistent with the purposes of" the Act or TARP or "otherwise contrary to the public interest." If such a determination is made, Treasury must "seek to negotiate" with the TARP recipient and the individual employee for "appropriate reimbursements" to the U.S. Government.
- **Say-on-Pay; Nonbinding Shareholder Vote on Executive Pay.** Each TARP recipient's proxy or other authorization for an annual or other shareholder meeting must permit a separate, nonbinding shareholder vote to approve the compensation of executives, as disclosed pursuant to current SEC compensation rules. The Act expressly states that any such vote cannot overrule a decision by the board of directors or limit the ability of shareholders to make proposals relating to executive compensation for inclusion in the proxy, and that the requirement to provide such vote does not create or imply any additional fiduciary duties on the board of directors. The SEC

is instructed to adopt final rules to implement this provision no later than February 17, 2010 (i.e., one year after the date of enactment of the Act). Because the SEC disclosure rules currently require disclosure of compensation paid in the prior fiscal year of the applicable institution, this vote would appear to be no more than a non-binding ratification (or non-binding disapproval) of the payment of such prior year's compensation.

- **Implementation of Policy Regarding Luxury Expenses.** Each TARP recipient's board of directors must implement a company-wide policy regarding "excessive or luxury expenditures" (examples given include entertainment, office/facility renovations, aviation/other transportation services and "other activities or events that are not reasonable expenses for staff development, reasonable performance incentives or other similar measures conducted in the normal course of business"). The legislation does not provide guidance on the definition of "excessive," "reasonable" or on the terms to be included in the policies, nor does it require publication of the policies.

The intense public scrutiny of executive compensation arrangements has given rise to significant limitations on executive and key employee pay practices at financial institutions receiving government assistance. While we have in some areas attempted to provide context for these new rules, the foregoing discussion must of necessity be general in nature. Further guidance from Treasury will need to be issued in order to help with the analyses of these provisions.

Therefore, TARP recipients, and institutions that are considering becoming TARP recipients, should contact us to address any questions they may have as they proceed with their participation. Only when Treasury provides its guidance will we be better able to evaluate the consequences of the restrictions that Congress has imposed on TARP recipients under the Act.

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