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# The Economic Stimulus Bill Adds New Restrictions on Executive Compensation and Corporate Governance for TARP Participants

The American Recovery and Reinvestment Act of 2009 ("ARRA"), which was signed into law on February 17, 2009, amends and replaces Section 111 of the Emergency Economic Stabilization Act of 2008 ("EESA"), which formed the basis of a number of the executive compensation limitation restrictions created under the Troubled Asset Relief Program ("TARP"). The new executive compensation restrictions apply to any company that has either received money or will receive money under the TARP Capital Purchase Program ("TARP-CPP"). These limitations and restrictions are significantly more onerous than the compensation restrictions previously announced under EESA, interim Treasury Rules, the TARP-CPP and the Treasury Department's ("Treasury") press release of February 3, 2009. ARRA requires the Secretary of the Treasury to promulgate implementing regulations, and until this occurs, there will be significant uncertainty regarding the meaning of certain provisions of ARRA.

## APPLICATION OF EXECUTIVE COMPENSATION RESTRICTIONS

The ARRA restrictions apply for as long as an entity has any outstanding obligation arising from financial assistance under TARP (the "TARP obligation period"). ARRA specifically provides that this period does not include any period after repayment of Treasury's investment, even if Treasury continues to hold warrants to purchase common stock of the TARP recipient. The standard Securities Purchase Agreement used by Treasury to invest in financial institutions under the TARP-CPP provides that Treasury may unilaterally amend any provision of the agreement to the extent required to comply with changes in federal law after the date of the agreement. Therefore, Treasury is expected to apply the new rules under ARRA to entities that have already received TARP assistance. For entities that have already received TARP, but do not wish to be bound by the new compensations restrictions, ARRA eases the restrictions on early repayment of TARP funds by allowing such repayment at any time.

## NEW EXECUTIVE COMPENSATION STANDARDS

ARRA provides that during the TARP obligation period, each TARP recipient shall be subject to executive compensation and corporate governance standards established by the Secretary of the Treasury, which standards shall include the following:

### Prohibition Against Bonuses, Retention Awards or Incentive Compensation

A TARP recipient is prohibited from paying or accruing any bonus, retention award, or incentive compensation to certain persons during the TARP obligation period (with two exceptions noted below).

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The number of persons affected by this prohibition depends upon the amount of financial assistance received:

- if less than $25 million, only the most highly-compensated employee is covered;
- if at least $25 million but less than $250 million, covered employees include the 5 most highly-compensated employees;
- at least $250 million but less than $500 million, covered employees include the senior executive officers and the 10 next most highly-compensated employees; and
- at least $500 million or more, covered employees include the senior executive officers and the 20 next most highly-compensated employees.

For any TARP recipient that received financial assistance of at least $25 million, Treasury may promulgate rules requiring a higher number of persons to be subject to this limitation. Under ARRA, "senior executive officer" means one of the top 5 most highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934.

*Exception for Restricted Stock*. The bonus prohibition does not apply to an award of restricted stock by the TARP participant provided the restricted stock:

- does not fully vest during the TARP obligation period;
- has a value that is not greater than one-third of the total amount of "annual compensation" of the employee receiving the stock; and
- is subject to such other terms and conditions as Treasury determines to be in the public interest.

*Exception for Employment Agreement Obligations*. The prohibition also does not apply to any bonus payment required to be paid pursuant to any written employment agreement executed on or before February 11, 2009 (subject to a determination of the validity of the agreement by the Secretary of the Treasury).

- **Observation:** A key interpretative issue will be the definition of "incentive compensation." In general, stock options and commission arrangements will likely constitute "incentive compensation," while pension arrangements will not.

**Prohibition Against Severance Pay**

No "golden parachute" payments may be made to a senior executive officer or any of the next 5 most highly compensated employees during the TARP obligation period. A "golden parachute" payment is defined in ARRA as any payment to a senior executive officer for departure from a company *for any reason*, except for payments for services performed or benefits accrued.

- **Observation**: EESA limited golden parachute payments to senior executive officers and the rules promulgated under EESA defined a golden parachute payment as a payment that equals or exceeds three times the executive's "base amount" (defined as the average of the last 5 years taxable compensation). The new rule generally prohibits *any payment* that has not already accrued (vested). This would negate any severance payments to such

persons in the event of an involuntary termination or change in control required by existing employment agreements and change in control agreements. Presumably, it would also negate certain payments that would accrue to the executive due to disability or death. Hopefully, Treasury regulations, when issued, will limit the reach of this onerous provision.

**Clawbacks and the Inaccurately Reported Earnings**

A TARP recipient must "clawback" any incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees that is based on statements of earnings, revenues, gains or other criteria that are found to be "materially inaccurate."

- **Observation:** The reach of ARRA's clawback provision is unrelated to an institution's size, so the expansion of the clawback requirement to the highest paid 25 employees applies to all TARP participants, regardless of size. For community banks, this provision would likely reach loan officers, mortgage originators, etc.

**"Unnecessary or Excessive Risk Taking"**

ARRA expands upon the restrictions against compensation that encourages "unnecessary or excessive risk" that threatens the value of the TARP recipient during the TARP obligation period. It provides that compensation plans may not encourage manipulation of the reported earnings of a TARP recipient to enhance the compensation of any of its employees.

- **General Observation on Executive Compensation Standards:** It is unclear whether the particular standards enumerated in ARRA, which ARRA states must be included in the standards established by Treasury, apply immediately or upon the establishment and promulgation of rules by Treasury.

## TREASURY REVIEW OF PRIOR PAYMENTS TO EXECUTIVES

Treasury is required to review the 2008 and 2009 bonuses, retention awards, and other compensation paid to the senior executive officers and the next 20 most highly-compensated employees of each TARP participant before the enactment of ARRA (February 17, 2009) to determine whether any of such payments were inconsistent with the purposes of ARRA or TARP or were otherwise "contrary to the public interest." If the Treasury makes such a finding, then it will "seek to negotiate" with the TARP recipient and the employee for appropriate reimbursement to the Federal Government with respect to salary or bonuses.

## LIMITS ON DEDUCTIBLE COMPENSATION

During the TARP obligation period, each TARP recipient is subject to the deduction limits of Section 162(m)(5) of the Internal Revenue Code ("Code"), as amended by EESA. This provision generally imposes a $500,000 limit on the annual deduction an institution may take for compensation paid to certain executive officers, and does not contain any exclusion for performance-based pay that is otherwise available under the general rule of Code Section 162(m) (which limits tax-deductible compensation for named executive officers of publicly traded companies to $1 million unless the compensation is performance-based*). ARRA does not otherwise limit the amount of overall compensation that may be paid to an employee.*

## CORPORATE GOVERNANCE REQUIREMENTS

ARRA requires TARP recipients to implement certain corporate governance standards that are designed to ensure compliance with the requirements of ARRA.

### Limitation on Luxury Expenditures

The board of directors of a TARP recipient *must* adopt a company-wide policy regarding "excessive" or "luxury" expenditures, as defined by the Secretary of the Treasury. At a minimum, the policy must cover entertainment or events, office and facility renovations, aviation and other transportation services, and "other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the participant's business operations."

### Board Compensation Committee

Each TARP recipient must establish a Board Compensation Committee (the "Compensation Committee") consisting entirely of independent directors, to review employee compensation plans. The Compensation Committee must meet at least twice a year and evaluate compensation plans in light of any risk posed by the plans to the TARP recipient. If the TARP recipient has no common or preferred stock registered under the Securities Exchange Act of 1934 and has received less than $25 million of TARP assistance, then its board of directors must conduct the evaluation in lieu of a separate Compensation Committee.

### Certification of Compliance

The chief executive officer ("CEO") or chief financial officer ("CFO") of each TARP recipient must provide a written certification that states that the institution has complied with all the compensation requirements of ARRA. Publicly-traded institutions must provide the certification to the Securities and Exchange Commission ("SEC") "together with annual filings under the securities laws," and other institutions must provide the certification to Treasury.

- **Observation:** ARRA expanded upon the framework set forth in EESA and prior Treasury rules, which required the Compensation Committee to review compensation arrangements for "unnecessary and excessive risks" and further required the CEO to make certain certifications to the Chief Compliance Officer ("CCO") regarding the TARP recipient's compensation arrangements (for a discussion of these rules, see our Bulletin, *Treasury Issues New Restrictions on Executive Compensation Under TARP*, dated February 9, 2009). We believe that these rules still apply, but are buttressed by the additional requirement that the Compensation Committee conduct this review bi-annually and further requires the CEO's (or CFO's) certification to be issued to the SEC or Treasury.

### Shareholder Vote on Executive Compensation

During the TARP obligation period, a TARP participant must "permit" a separate non-binding shareholder vote to approve the compensation of executives as disclosed in the Compensation Discussion and Analysis and related compensation tables. ARRA provides that the shareholder vote shall not be construed as overruling a decision by the board nor create or imply any additional fiduciary for a board.

## EARLY REPAYMENT OF TARP

ARRA allows TARP-CPP participants to repay the preferred stock without regard to waiting periods and without having to conduct a qualified equity offering, subject to consultation with the participant's Federal bank regulator. If the investment is repaid, the Treasury shall "liquidate [the] warrants associated" with the investment at the "current market price."

- **Observation:** Participants seeking early repayment of TARP will want to develop a sound business reason for such repayment to avoid the perception that repayment was primarily related to compensation restrictions.

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