

American Recovery and Reinvestment Act of 2009 Expands Executive Compensation Restrictions for TARP Recipients

February 18, 2009

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the 2009 Recovery Act) that was passed by the House and Senate on February 13, 2009. In addition to providing a massive federal investment in energy, transportation and infrastructure, education and health care projects, the 2009 Recovery Act expands upon the executive compensation restrictions for entities participating in the Troubled Asset Relief Program (TARP) enacted in fall 2008 as part of the Emergency Economic Stabilization Act (EESA). These restrictions are located in Title VII of Division B of the 2009 Recovery Act, available at http://www.house.gov/billtext/hr1_cr_jesb.pdf.

The most significant executive compensation restriction in the 2009 Recovery Act limits the amount and timing of incentive compensation and retention bonuses that may be paid by TARP recipients to their executives before satisfying all obligations arising from financial assistance provided under the TARP. Up to 25 executives may be limited by this restriction depending upon the amount of TARP financial assistance. The 2009 Recovery Act also prohibits severance benefits that may be paid to named executive officers and the five next most highly compensated employees of a TARP recipient, and limits amounts that may be deducted for executive compensation. Shareholders at these institutions must also be provided a “say on pay.” Subject to certain payments under employment agreements entered into on or before February 11, 2009, these restrictions are retroactive and cover existing and future financial institutions receiving TARP financial assistance.

The 2009 Recovery Act provides expansive authority to the secretary of the Treasury to define and implement “appropriate standards for executive compensation and corporate governance.” The cap on bonuses that may be paid by financial institutions receiving TARP financial assistance is at odds with the Obama administration proposal issued on February 4, 2009, which would have only imposed this type of restriction for institutions receiving “exceptional assistance.” Further information regarding the Obama administration proposal is available in McDermott’s *On the Subject* “Restrictions on Executive Compensation Under EESA,” available at <http://mwe.com/ots0209-ee>. Without reasonable and balanced regulatory standards, financial institutions that have received TARP financial assistance may seek to repay amounts on an accelerated basis, as the 2009 Recovery Act does not impose a general obligation to replace these funds from another source.

It is reasonable to anticipate that these restrictions in the 2009 Recovery Act are a harbinger of additional legislative and regulatory activity that are likely to affect executive compensation practices in the near future. Representative Barney Frank has already promised executive compensation hearings later this year to implement “say on pay” legislation, and other members of Congress have expressed interest in extending certain restrictions under EESA to all public companies.

The 2009 Recovery Act requires the secretary of Treasury to implement the following restrictions on any financial institution prior to satisfaction of its obligations under TARP to the U.S. Treasury (TARP Restricted Period) as part of its executive compensation and corporate governance standards.

Limit on Incentive Compensation and Bonuses

The 2009 Recovery Act prohibits a TARP recipient from “paying or accruing any bonus, retention award, or incentive compensation” to certain covered executives during the TARP Restricted Period. The covered executives subject to this restriction are determined based on the amount of TARP financial assistance as follows:

Amount of TARP Financial Assistance	Covered Executives
Less than \$25 million	Most highly compensated employee
At least \$25 million but less than \$250 million	5 most highly compensated employees
At least \$250 million but less than \$500 million	All named executive officers* and the next 10 most highly compensated employees

* A “named executive officer” is an executive officer who is named in the summary compensation table (or would be named if the TARP recipient were a public company).

Amount of TARP Financial Assistance	Covered Executives
\$500 million and more	All named executive officers and the next 20 most highly compensated employees

If the amount of TARP financial assistance is at least \$25 million, the secretary of the Treasury may increase the number of highly compensated employees who are subject to this restriction in its discretion. The 2009 Recovery Act does not define who is a “highly compensated employee” for purposes of this restriction.

Placing an absolute limit on incentive compensation and bonuses is a significant departure from prior legislative and regulatory attempts to curb perceived executive compensation abuses, which have primarily focused on limiting tax deductions (under Section 162(m) and Section 280G of the Internal Revenue Code) and providing better disclosure to shareholders (under revised proxy rules under Item 402 of Regulation S-K).

There are two important exceptions to this prohibition.

LONG-TERM RESTRICTED STOCK

The 2009 Recovery Act allows a TARP recipient to “pay” long-term restricted stock under the following conditions:

- The covered executive must not earn vested rights to the long-term restricted stock during the TARP Restricted Period.
- The long-term restricted stock cannot have a value that exceeds one-third of the “total amount of annual compensation” of the covered executive.
- Compliance with any other restrictions that may be imposed by the secretary of the Treasury.

The statutory language in the 2009 Recovery Act raises several questions that will be of critical interest to TARP recipients seeking to retain executives, including what is “long-term restricted stock” (which is not defined in the 2009 Recovery Act) and how and when to determine what is “total annual compensation.” For example, are benefits such as annual increase in supplemental pension and other benefits included in total annual compensation, and can a TARP recipient award restricted stock on an accelerated basis in 2009 based on the anticipated TARP Restricted Period.

GRANDFATHERED EMPLOYMENT AGREEMENTS

The incentive compensation and bonus restrictions do not apply to “any bonus payment” that is required to be paid under a “written employment contract” that is executed on or before February 11, 2009. The 2009 Recovery Act charges the secretary of the Treasury or a designee to determine what constitutes a “valid employment agreement” for this purpose. Presumably this restriction will apply not only to bonuses accrued under nonqualified deferred compensation plans but also bonus opportunities required to be provided under employment agreements.

Unlike the legislative proposal by Senator Claire McCaskill that would have imposed a \$400,000 limit on total annual compensation, which is the annual amount of compensation earned by the president of the United States, the 2009 Recovery Act does not expressly limit how much can be paid to an executive in the form of salary or other employee benefits. While bank executives have historically been paid most of their annual cash compensation in the form of annual bonuses, the 2009 Recovery Act provides an incentive for TARP recipients that will not be able to accelerate repayment of TARP financial assistance to reconsider that practice.

No Incentives for “Unnecessary and Excessive Risks” or Earnings Manipulation

Similar to EESA, the 2009 Recovery Act requires that all TARP recipients not establish incentives for named executive officers to take “unnecessary and excessive risks” that would threaten the entity’s value during the TARP Restriction Period. The 2009 Recovery Act also incorporates an earlier legislative proposal to require rules that prohibit any arrangement that “would encourage manipulation of reported earnings” of the TARP recipient to increase the compensation to any of its employees. While the exact scope of this provision remains to be seen, its importance has been somewhat muted because of the prohibitions against incentive compensation and bonuses during the TARP restriction period.

No Golden Parachutes

The 2009 Recovery Act prohibits any “golden parachute payment” to a named executive officer or any of the next five most highly compensated employees. A “golden parachute payment” for this purpose is defined to include “any payment . . . for departure from a company for any reason, except for payments for services performed or benefits accrued.” EESA had defined a “golden parachute” with reference to the rules under Section 280G of the Internal Revenue Code, which would have allowed for severance benefits up to three times the executive’s base compensation (*i.e.*, taxable compensation for five years prior to the year of severance) less \$1. Unlike the incentive compensation restriction described above, there is no grandfathering restriction for severance arrangements that were previously permissible under EESA (or the Obama administration guidance on February 4, 2009). It remains unclear whether a TARP recipient can pay amounts for post-termination obligations (such as a non-compete or non-solicitation covenant) without violating this restriction.

No Deductible Compensation in Excess of \$500,000

The 2009 Recovery Act imposes the \$500,000 annual limit on deductible compensation to certain senior executives under EESA (Section 162(m)(5) of the Internal Revenue Code) to apply to all TARP recipients during the TARP Restricted Period.

Limitation on Luxury Expenditures

Similar to the Obama administration guidance, the 2009 Recovery Act requires that the board of directors of a TARP recipient must adopt “a company-wide policy” regarding “excessive or luxury expenditures” as identified by the secretary of Treasury. This policy may include “excessive expenditures” on the following:

- Entertainment or events
- Office and facility renovations
- Corporate aircraft and other transportation
- “Other activities or events that are not reasonable expenditures for staff development, reasonably performance incentives, or other similar measured conducted in the normal course of business operations of the TARP recipient”

It remains to be seen whether the secretary of Treasury will require that these policies include a prohibition against items that it identifies as “excessive expenditures.” There is no grandfathering protection for fringe benefits under written employment agreements in place before February 11, 2009.

Expanded Clawback Rights

The 2009 Recovery Act provides for all TARP recipients to recover “any bonus, retention award or incentive compensation” paid to a named executive officer and any of its next 20 most highly compensated employees as a result of any statement of earnings, revenues, gains or other criteria that are later found to be “materially inaccurate.” This provision incorporates the guidance applicable to the Capital Purchase Program to all TARP recipients and extends recovery rights beyond the top five executive officers.

New Compensation Committee Governance Requirements

The 2009 Recovery Act requires each TARP recipient to establish a board compensation committee that is composed entirely of independent directors for the purpose of reviewing compensation plans (unless the TARP recipient is a private company that has received less than \$25 million in TARP financial assistance). The text of the legislation provides no indication regarding what factors should be considered by the secretary of the Treasury in defining who is “independent” for this purpose. The board compensation committee must meet at least semi-annually to evaluate the compensation plans “in light of an assessment of any risk posed to the TARP recipient from such plans.”

Required CEO and CFO Certifications

The chief executive officer and chief financial officer of a TARP recipient must provide a written certification of compliance with the requirements discussed above (with the exception of the limitation on luxury expenditures). A publicly traded company must provide the required certification to the U.S. Securities and Exchange Commission (SEC) (presumably as part of the Compensation Discussion and Analysis required under Item 402 of Regulation S-K) and a non-publicly traded company must provide the certification to the secretary of the Treasury.

Say on Pay

The 2009 Recovery Act requires each TARP recipient to provide its shareholder an advisory, non-binding vote on executive compensation. This provision implements the “say on pay” legislative proposal initially introduced by Representative Barney Frank in 2007. Frank has publicly stated that he will push to extend a similar “say on pay” provision for all public companies. The SEC is directed to issue final regulations and rules regarding the “say on pay” provision under the 2009 Recovery Act.

Review of Prior Bonus Payments

The secretary of the Treasury is directed to “review bonuses, retention awards, and other compensation” paid to named executive officers and the next 20 most highly compensated employees of any TARP recipient that were paid prior to February 18, 2009, to determine whether “any such payments were inconsistent with the purposes of this section [setting forth executive compensation and corporate governance standards] or were otherwise contrary to the public interest.” If the secretary determines that any payment violated this standard, the secretary is required to negotiate with the TARP recipient and the applicable employee(s) “for appropriate reimbursement to the federal government with respect to compensation and bonuses.” This legislative direction may affect existing investigations by state attorneys general in New York and North Carolina.

Withdrawal by TARP Recipients

Under EESA, the Treasury had required banks receiving TARP financing assistance under the Capital Purchase Plan to retain the cash for three years or raise amounts from third parties to replace it. The 2009 Recovery Act now provides an opportunity for TARP recipients to immediately repay any TARP financing assistance without first needing to raise any funds, “subject to consultation” by the secretary of the Treasury with the appropriate federal banking agency. It seems this provision was included at the request of some TARP recipients seeking to make early repayment. It remains to be seen whether financial institutions that want to avoid the amended EESA restrictions will be able to take advantage of this early exit opportunity. The nature of the “consultation” process is not defined under the 2009 Recovery Act, and banking regulators might seek to require a withdrawing TARP recipient to raise additional funds from third parties if the regulators determine that there are not otherwise sufficient capital reserves. Upon repayment, the secretary is required to liquidate any warrants it received from the TARP recipient at current market prices.

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