

The Stimulus Bill Imposes Further Executive Compensation Restrictions

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The American Recovery and Reinvestment Act of 2009 (the stimulus bill) that President Obama signed into law on February 17 contains the latest attempt to limit compensation paid, and other benefits provided, to executives of those entities receiving governmental assistance under the Troubled Asset Relief Program (TARP). This LawFlash summarizes the restrictions and requirements imposed upon those entities under the stimulus bill, as well as the prior relevant guidance.

Background

Since October 3, 2008, the date on which TARP was established as part of the Emergency Economic Stabilization Act of 2008 (EESA), Congress and the White House have each issued legislation and guidelines regulating the timing, form, and amount of compensation that can be paid to executives employed by financial and other institutions receiving government assistance under TARP.

By way of a brief summary, TARP was originally created to permit the U.S. Department of Treasury (Treasury) to address financial institutions' troubled assets. In October 2008, Treasury provided initial guidance on the executive compensation provisions applicable to institutions under TARP in the Interim Final Rule (Initial Rule). On January 16, 2009, Treasury proposed changes to the Initial Rule (Interim Final Rule) to set forth additional guidance on executive compensation and corporate governance under TARP. On February 4, 2009, the White House and Treasury issued a press release (Press Release) announcing new guidelines on executive compensation for financial institutions receiving government assistance under TARP. A Morgan Lewis LawFlash (February 5, 2009) regarding the Press Release is available at

<http://www.morganlewis.com/index.cfm/fuseaction/publication.detail/publicationID/2c87e1e0-303d-479e-b2d2-2d90edd552ab>.

The American Recovery and Reinvestment Act of 2009: The Impact of the Stimulus Bill

The stimulus bill contains additional restrictions on executive compensation. While the stimulus bill amends the prior guidance issued under TARP, it does not provide a stated effective date. Instead the Secretary of the Treasury is instructed to promulgate regulations to implement the provisions of the stimulus bill. Therefore, final requirements for executive compensation under TARP, as originally contemplated under prior guidance and modified and expanded under the stimulus bill, will be set forth in the future regulations. Because there is considerable uncertainty about the scope of the stimulus bill's provisions in this area, this further guidance will be very important.

The provisions of the stimulus bill affecting executive compensation will apply to all entities that have received or will receive financial assistance under TARP. Institutions that have already received government assistance under TARP, as well as those that participate in TARP in the future, will be required to comply with the same restrictions and requirements with respect to executive compensation and corporate governance. Therefore, the new limitations set forth in the stimulus bill will apply retroactively to many institutions that are already receiving financial assistance under TARP.

The stimulus bill generally expands the executive compensation provisions that were part of the TARP legislation, incorporates many of the provisions set forth in the Press Release, and contains additional restrictions. However, many of the directives set forth by the Obama administration were altered prior to their inclusion in the stimulus bill. For example, the stimulus bill eliminated the distinction between institutions receiving “exceptional assistance” from the government and institutions participating in generally available capital access programs. Additionally, it appears that the new standards set forth in the stimulus bill will apply to all TARP participants and, contrary to what was stated in the Press Release, will apply retroactively to those institutions that have received governmental assistance under TARP, including institutions that have participated in the Treasury’s Capital Purchase Program, as well as institutions receiving future financial assistance. These restrictions and requirements, as originally implemented by prior legislation and as modified by the stimulus bill, are summarized below.

Restrictions on Executive Compensation

Senior Executive Officers. The executive compensation requirements contained in the stimulus bill generally apply to the senior executive officers (SEOs) of a participating institution. In some instances, however, the requirements in the stimulus bill apply to a broader executive population beyond the SEOs.

The stimulus bill retains the SEO definition from the EESA and identifies an SEO as one of the five highest-paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934 (the Exchange Act), as well as of nonpublic company counterparts. It appears that SEOs may still be identified using the guidelines established in the Initial Rule and later amended in the Interim Final Rule. These guidelines make it clear that, for purposes of determining what constitutes a “participating institution,” the parent-subsidiary controlled group rules apply but the brother-sister controlled group rules are disregarded. While entities under common control are treated as a single employer, entities that simply have common ownership are not treated as a single employer. Therefore, for purposes of TARP, the SEOs of the participating institution, taking into consideration applicable controlled group rules, include all of the following:

- The principal executive officer (i.e., the CEO)
- The principal financial officer (i.e., the CFO)
- The three most highly compensated executive officers, determined by applying definitions from the Exchange Act and Regulation S-K. However, for these purposes, compensation includes total compensation for the fiscal year, without regard to whether the compensation is includible in the executive officer’s gross income

It should be noted that the scope of the SEO definition under the stimulus bill may differ from other relevant definitions of executive groups under other tax and securities law provisions (such as under section 162(m) of the Internal Revenue Code of 1986, as amended (Code)). In particular, under the

stimulus bill, once an executive is deemed an SEO, he or she retains that status even after a separation of service.

Duration of Restrictions. The stimulus bill provides that the restrictions on executive compensation are applicable during the entire period in which any obligation arising from financial assistance provided under TARP remains outstanding. The stimulus bill does exclude, however, any period during which the federal government only holds warrants to purchase common stock of the TARP recipient. The period during which the executive compensation restrictions are in place is referred to as the “Restriction Period.”

Compensation Limitations. The stimulus bill imposes a new prohibition on the payment or accrual of any bonuses, retention awards, or incentive compensation to certain executives but retains the \$500,000 tax deduction limit under section 162(m) of the Code. Conversely, in a provision not included in the stimulus bill, the Press Release limited the total amount of all compensation, including salary, bonus, and incentive compensation that could be paid to each SEO, to \$500,000. For purposes of TARP, the following compensation limitations will be imposed during the Restriction Period:

- ***Incentive Compensation (General Prohibition).*** The stimulus bill states that a participating institution may not, during the Restriction Period, pay or accrue any bonus, retention award, or incentive compensation to certain identified executives. For these purposes, it appears that an amount is accrued when it is earned, and thus that deferrals of compensation will not avoid these limits. The stimulus bill provides an exception to this rule for amounts paid by the issuance of long-term restricted stock, so long as such restricted stock (i) does not fully vest during the Restriction Period, (ii) does not have a value that is greater than one-third of the total amount of annual compensation of the employee receiving the stock, and (iii) is subject to other terms and conditions as Treasury determines to be in the public interest. For purposes of (ii), an employee earning \$1 million in salary (or other forms of compensation) may receive an additional \$500,000 in restricted stock (as \$500,000 is one-third of \$1.5 million, which equals the employee’s total compensation, taking into account the awarded restricted stock).

The specific “identified executives” subject to this prohibition depends upon the amount of financial assistance received by the participating institution.

- If the financial assistance is less than \$25 million, the prohibition applies only to the most highly compensated employee.
- If the financial assistance is at least \$25 million but less than \$250 million, the prohibition applies to at least the five most highly compensated employees (or such higher number as Treasury determines to be in the public interest).
- If the financial assistance is at least \$250 million but less than \$500 million, the prohibition applies to the CEOs and at least the 10 most highly compensated employees (or such higher number as Treasury determines to be in the public interest).
- If the financial assistance is \$500 million or more, the prohibition applies to the CEOs and at least the 20 most highly compensated employees (or such higher number as Treasury determines to be in the public interest).

In addition, the stimulus bill provides that the prohibition described above does not apply to any bonus payment required to be paid pursuant to a written employment contract that was executed on or before February 11, 2009 and found to be valid by Treasury.

- *No Amounts Paid for Excessive Risk.* To the extent an SEO is entitled to receive a payment of incentive compensation, taking into consideration the general prohibition requirements set forth above, such SEO may not be paid any incentive compensation that would encourage unnecessary or excessive risk-taking that threatens the value of the participating institution during the Restriction Period. Further, any compensation plan that encourages manipulation of the reported earnings of the participating institution to enhance the compensation of any of its employees is prohibited.
- *Deduction Limits.* As mentioned above, each participating institution must agree to a \$500,000 annual tax-deduction limit for each SEO's total annual compensation. Total annual compensation is determined based upon all forms of compensation, including commissions and other incentive or performance-based amounts (i.e., unlike under section 162(m) of the Code, performance-based compensation would not qualify as an exception to the deduction limitation).

Ban on Golden Parachute Payments. The stimulus bill prohibits the payment of any golden parachute payments to any SEO or to any of the next five most highly compensated employees during the Restriction Period. The stimulus bill generally defines a "golden parachute payment" to mean any payment for departure from a company for any reason, except for payment for services performed or benefits accrued. A change of control is not necessary to trigger the golden parachute payment prohibition. Thus, this provision appears to restrict or even prohibit the payment of severance with respect to the 10 highest-paid executives, whether or not a change in control occurs.

The Press Release extended TARP's general prohibition on golden parachute payments (which originally applied only to SEOs) to prohibit any golden parachute payment to any SEO or to any of the next five senior executives (thus, to 10 employees). Furthermore, the Press Release also limited the availability of golden parachute payments to be made to the next 25 senior executives upon severance of employment. While the stimulus bill did expand upon the original restrictions on golden parachute payments by providing that a participating institution must prohibit any golden parachute payment to any SEO or to any of the next five most highly compensated employees during the Restriction Period, it did not include the additional restrictions contemplated by the Press Release for the next 25 senior executives.

The stimulus bill also appears to have broadened the scope of the definition of "golden parachute payment." Under the Initial Rule, a golden parachute payment was a payment made on account of an applicable severance from employment to the extent that the aggregate amount of the payment equals or exceeds three times the affected employee's average total compensation during the preceding five years (which roughly parallels the current provisions of section 280G of the Code). The stimulus bill disallows any payment to any SEO or to any of the next five most highly compensated employees upon severance from employment, regardless of the amount of such payment. In neither case is a change in control required, thus obviating the meaning of "golden parachute."

Clawback Requirements. The stimulus bill expands the TARP clawback provisions to apply to any SEO and to any of the next 20 most highly compensated employees. To participate in TARP, a participating institution and each applicable employee must agree to apply a clawback to incentive compensation if a payment was based on statement of earnings, revenues, gains, or other criteria that are later found to be

materially inaccurate. In other words, the CEO would have to repay any incentive compensation earned as a result of such inaccurate financial statements. While the stimulus bill does not provide specifics as to the clawback requirements, it appears to maintain these requirements in the same form as originally contemplated for purposes of TARP (with the exception of now applying such requirements to a broader population as opposed to only CEOs). Therefore, the prior guidance provided with respect to the clawback provisions, as described below, still appears to apply.

- The bonus and incentive compensation that is subject to clawback is any bonus and incentive compensation to which an executive obtains a legally binding right during the Restriction Period, regardless of when the compensation is paid.
- An institution is not required to recover incentive compensation earned based on financial statements that become materially inaccurate solely because of revisions to generally accepted accounting principles where the financial statements were accurate based on generally accepted accounting principles applicable when the payment was made.
- Unlike a similar clawback under the Sarbanes-Oxley Act of 2002, the TARP clawback (i) is not limited to the CEO and CFO; (ii) applies to both public and private institutions; (iii) is not exclusively triggered by an accounting restatement (i.e., the TARP clawback is triggered by any material inaccuracy in the financial statements); (iv) does not limit the recovery period; (v) covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation; and (vi) does not require a showing of “misconduct.”

Review of Prior Payments. The stimulus bill imposes a new review requirement with respect to bonus, retention awards, and other compensation already paid to any CEO and to the next 20 most highly compensated employees. This requirement includes a review by Treasury of amounts paid prior to the date of enactment of the stimulus bill to determine whether such payments were inconsistent with the purposes of the stimulus bill or TARP or were otherwise contrary to public interest. If any of the prior payments do prove to be inconsistent with such purposes, Treasury will seek to negotiate with the participating institution and the affected employee for appropriate reimbursement.

Corporate Governance Requirements

Certification Requirements. The stimulus bill requires the CEO and CFO (or equivalents thereof) of each participating institution to provide a written certification of compliance with the various executive compensation requirements under TARP. For public companies, such written compliance must be provided to the Securities and Exchange Commission together with annual filings required under securities laws. For nonpublic companies, such written compliance must be provided to Treasury. It is likely that additional descriptions with respect to the timing and content of such certifications will be included in future Treasury regulations.

Board Compensation Committee. As contemplated by the Press Release, the stimulus bill imposes a new requirement that each participating institution establish a compensation committee. The compensation committee must be composed entirely of independent directors and must review employee compensation plans. The compensation committee must meet at least semiannually to evaluate employee compensation plans in light of an assessment of any risk posed to the participating institution from such plan. If the participating institution is not publicly traded and has received financial assistance of \$25 million or less,

the duties of the compensation committee may be carried out by the board of directors, and no separate compensation committee will be required for such entities.

Luxury Expenditures. Also as contemplated by the Press Release, the stimulus bill requires the board of director of each participating institution to adopt a companywide policy on amounts related to excessive or luxury expenditures, such as entertainment or events, office and facility renovations, aviation or other transportation services, or other activities or events that are not reasonable expenditures for staff development, performance incentives, or other similar measures in the normal course of business. Unlike the Press Release, however, the stimulus bill does not appear to require CEOs to certify expenditures that could be viewed as luxury items, nor does it require that such expenditure policies have to be posted on each institution's website.

Nonbinding Shareholder Vote. The stimulus bill imposes a nonbinding shareholder vote requirement. During the Restriction Period, any participating institution must permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the disclosure rules of the Securities and Exchange Commission. The vote will be nonbinding. This means that such vote may not be construed as overruling a decision by the board of directors nor will such vote create or imply any additional fiduciary duty for the board of directors. Finally, the vote does not limit the ability of shareholders to make proposals on executive compensation for inclusion in proxy materials. The Securities and Exchange Commission will provide additional rules and regulations with respect to the nonbinding shareholder vote within one year after the date of the enactment of the stimulus bill.

Withdrawal by a Participating Institution

TARP originally required a participating institution either to retain any financial assistance received from the federal government for at least three years or to repay it within the three-year period only if the institution raised a similar amount of money from private sources. The stimulus bill has modified this requirement to provide that Treasury must permit a participating institution to repay such financial assistance without regard to whether the institution has replaced the funds from any other source or satisfied any waiting period. Upon repayment, Treasury will liquidate the warrants associated with such assistance at the current market price. The institution must still consult with the appropriate regulatory agency, which may require additional funds to be raised.

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