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STIMULUS LAW REQUIRES TARP COMPANIES TO "STOP, LOOK, AND LISTEN" BEFORE PAYING EXECUTIVE COMPENSATION

The American Recovery and Reinvestment Act of 2009 (the "Act"), enacted today, provides the following rules applicable to any company receiving past or future TARP funds ("TARP Companies") for certain employees (usually the "Top 5 Executive Officers," but also, in some cases, other highly paid employees and not just executives) during the period the federal government holds preferred stock of the TARP Company. There are many issues and questions to address over the next few weeks. We highlight below the Act's most significant provisions requiring TARP Companies to "**stop**" the operation of their executive compensation programs, to "**look**" at how the Act impacts those programs, and to "**listen**" for expected guidance from the Treasury Department implementing this new law.

- **SEVERANCE PROHIBITION:** The Act requires a prohibition on any payment made to a Top 5 Executive Officer and the next 5 "most highly compensated employees" for a "departure" from the TARP Company for any reason, except for payment for services performed or benefits accrued. Pre-Act rules only limited severance pay on an involuntary termination of Top 5 Executive Officers to 3x their 5-year average pay. The Act bars all "departure payments," obviously a much broader standard.
- **SALARIES:** The Act does not contain a cap on salaries. Salaries may be the only way to pay for top talent, since other incentive compensation is now severely limited, as described below. Note, however, that the original TARP \$500,000 tax deductibility cap remains in place for the Top 5 Executive Officers.
- **BONUS/LTI PROHIBITION; LIMITED EXCEPTIONS:** TARP Companies cannot pay or accrue any bonus, retention award, or incentive compensation to certain highly compensated employees. The number of employees depends on the amount of TARP money received: (i) up to \$25m, then just the highest paid employee; (ii) \$25m to \$250m, the highest 5; (iii) \$250m to \$500m, the highest 15; and (iv) over \$500m, the highest 25. There are 2 exceptions to the ban: (1) bonuses may be paid per written employment agreements executed on or prior to February 11, 2009, and (2) bonuses may be paid in the form of restricted stock with a maximum value of up to 1/3 of total annual compensation that cannot fully vest before the government's preferred stock is redeemed in full. Questions surrounding the time frames for determining the top paid employees, "annual compensation," and the treatment of outstanding long-term compensation (e.g., options, restricted shares, performance awards) require immediate answers.
- **NO UNNECESSARY AND EXCESSIVE RISKS:** The Act mandates that the compensation of the Top 5 Executive Officers excludes incentives involving unnecessary and excessive risks that threaten the value of the TARP Company. Pre-Act law required only periodic review of the risk by the TARP Company's compensation committee.
- **BONUS CLAWBACK:** TARP Companies must recover any bonus, retention award, or incentive compensation paid to the Top 5 Executive Officers and the next 20 "most highly compensated employees" based on materially inaccurate statements of earnings, revenues, gains, or other criteria. Pre-Act rules limit clawback to just the Top 5 Executive Officers.
- **NO INCENTIVE PLAN THAT ENCOURAGES MANIPULATION OF REPORTED EARNINGS:** The Act prohibits any compensation plan that encourages manipulation of the TARP Company's reported earnings to enhance the compensation of any employee. This may outlaw the use of EBITDA, net income, EPS and similar performance metrics.
- **REVIEW OF PRIOR PAYMENTS:** The Treasury Secretary is authorized to review bonuses, retention awards, and other pre-Act compensation paid to the Top 5 Executive Officers and the next 20 "most highly compensated employees" for payments inconsistent with the purposes of the Act or that were otherwise contrary to the public interest. The Treasury Secretary is directed to "negotiate" with the TARP Company and the executive/employee for appropriate recovery of any such payments.
- **CERTAIN PERQUISITES:** The TARP Company board of directors must have in place a company-wide policy regarding excessive or luxury expenditures, as identified by the Treasury Secretary, which may include excessive expenditures on: (i) entertainment or events; (ii) office and facility renovations; (iii) aviation or other transportation services; and (iv) other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures.
- **SAY ON PAY:** Annual or other shareholder meeting proxies must permit a separate nonbinding shareholder vote to approve executive compensation. The Act directs the SEC to promulgate proxy rules for "say on pay" within one year, presumably taking away the need to include the proposal in this year's proxy. Hopefully, Treasury guidance will confirm this because including a "say on pay" vote would require a preliminary filing with the SEC.
- **COMPENSATION COMMITTEE REVIEW AND CEO/CFO CERTIFICATIONS:** The Act contains provisions requiring independent compensation committees and a twice-a-year review of the compensation programs in relation to risk. The Act also requires that written certification of compliance by the CEO and the CFO be provided to either the SEC if the company is publicly traded or the Treasury Secretary if the company is privately held.
- **ENDING TARP RESTRICTIONS:** Recognizing the change of the rules in the middle of the game, the Act liberalizes the repayment of TARP funds by permitting redemption without raising additional capital, provided that the TARP Company otherwise satisfies its primary regulator that it has the wherewithal for the redemption.