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Stimulus Act Expands Executive Compensation Restrictions for TARP Recipients

The American Recovery and Reinvestment Act of 2009 ("ARRA") that was signed into law on February 17, 2009, amended the Emergency Economic Stabilization Act of 2008 ("EESA"), which imposed certain executive compensation limits on companies receiving assistance under the U.S. Treasury Department's Troubled Asset Relief Program ("TARP"). This advisory highlights the enhanced executive compensation restrictions which the ARRA imposes on recipients of TARP funding ("TARP Recipients"). The restrictions discussed below apply to all TARP Recipients, regardless of whether the TARP funds were received prior to or after the enactment of the ARRA. Such restrictions generally apply for the period during which any obligation arising from the receipt of TARP funds remains outstanding, but do *not* apply to any period during which the federal government only holds warrants to purchase the TARP Recipient's common stock (the "TARP Period").

Restrictions on Bonuses & Incentive Compensation. Subject to the exceptions listed below, a TARP Recipient may not pay or accrue any "bonus, retention award, or incentive compensation" to certain employees. The number and identity of the employees affected by this restriction depends on the amount of TARP funds received, as illustrated by the chart below.

TARP Funds Received	Covered Employees
Less than $25 million	Most highly compensated employee
At least $25 million, but less than $250 million	Five most highly compensated employees*
At least $250 million, but less than $500 million	SEOs** and 10 next most highly compensated employees*
$500 million or more	SEOs** and 20 next most highly compensated employees*

Many commentators believe TARP Recipients will respond to these requirements by increasing the base salaries of affected executives to make up for foregone bonuses. If a TARP Recipient is considering this option, it should be mindful of possible criticism from shareholders and other quarters (*e.g.*, legislators and regulators), its own disclosed polices and guidelines for setting base salaries (including benchmarking practices) and the limit (described below) on the deductibility of certain compensation amounts.

* The Treasury Secretary has the power to increase this number if he determines it to be in the public interest with respect to any TARP Recipient.

** An "SEO" (Senior Executive Officer) is an individual who is one of the top five most highly paid executives, and whose compensation is required to be disclosed (or would be required to be disclosed if the company was publicly traded) pursuant to federal securities laws.

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Restricted Stock Exception. Payment in long-term restricted stock is exempt from the above prohibitions if it (i) does not "fully vest" during the TARP Period, (ii) has a value less than or equal to 1/3 of the restricted stock recipient's total annual compensation, and (iii) is subject to any other terms and conditions that the Treasury Secretary deems to be in the public interest.

It may be prudent for TARP Recipients to review the number of authorized shares available under their equity plans because those existing shares may be used faster than originally contemplated due to the fact that (i) restricted stock will likely be the main tool for TARP Recipients to provide incentive compensation during the TARP Period and (ii) stock prices may decrease due to the current negative economic climate. Of course, authorizing more shares for issuance under an equity plan will require shareholder approval, which might be difficult given current shareholder sentiment.

It is also unclear how the phrase "fully vest" should be interpreted in this context. The phrase might mean that any grantee must forfeit his or her restricted stock if he or she terminates employment before the TARP Period ends. It is unclear what the policy basis for the interpretation would be. Or the phrase might mean imposing the end of the TARP Period as an additional criterion for a grantee to receive payment. Under this view, a grantee could vest when he or she completes whatever the TARP Recipient's normal vesting criteria are, but not be entitled to receive the restricted shares until the end of the TARP Period, regardless of whether the grantee is employed by the TARP Recipient at such time. We believe the latter view is the better one, as it is consistent with the clear purpose of the restriction, which is simply to ensure that the Treasury is repaid before such bonuses. If adopting the second view, a TARP Recipient should be careful to assess whether such an arrangement would cause accelerated and/or adverse tax consequences, including under Sections 83 or 409A of the federal tax code.

Employment Agreement Exception. The ARRA grandfathers any bonus payment required by a written employment contract executed before February 12, 2009, from the incentive compensation restriction, unless the Treasury Secretary, exercising his discretion, determines that the agreement is "invalid." It is unclear what criteria the Treasury Secretary might use to determine whether an agreement is "invalid" until further guidance is issued. Subject to such further guidance, we believe that any compensation-related agreement evidenced by writing, including a grant under the compensation plan, which is enforceable under principles of state contract law, should fit within the exception.

Prohibition on Severance Payments. During the TARP Period, the TARP Recipient may not pay any SEO or any of the next five highest-paid employees any amount on account of such employee's termination of employment with the TARP Recipient, unless the payment is for services or benefits already accrued. Whether this requirement applies to severance payments to an executive whose employment was terminated prior to the ARRA's enactment is unclear, and the Treasury Department has indicated that it is considering this issue. Also, it is conceivable that this provision may encourage highly paid executives of TARP Recipients to request decreases in their compensation so that they are no longer among the top five highest-paid employees and can therefore receive severance protection.

Recoupment/Clawback of Bonus & Incentive Compensation. A TARP Recipient must recoup any "bonus, retention award or incentive compensation" from any of its SEOs or any of its next 20 most highly compensated employees if such bonus, retention award or incentive compensation was paid based on statements of earnings, revenues, gains or other criteria that are later found to be "materially inaccurate." This provision applies without regard to whether the executive was involved with or had any knowledge of the material inaccuracies. This is the same standard that was set forth in EESA.

No Incentives for Excessive Risk-Taking. A TARP Recipient is prohibited from establishing incentives that would encourage any SEO to take "unnecessary and excessive risks that threaten the value" of the TARP Recipient. This is the same standard that was set forth in EESA.

Compensation Deduction Limited to $500,000. The ARRA maintains the deductibility limits imposed by EESA which disallow any TARP Recipient from deducting any compensation paid to any SEO in excess of $500,000 on its federal tax return. Although it is unclear, this restriction might be interpreted to apply after the TARP Period to deferred compensation amounts that were earned during the TARP Period but paid after the TARP Period ends.

Luxury Expenditure Policy. Each TARP Recipient must adopt a company-wide policy regarding "excessive or luxury expenditures," which may include (1) entertainment or events, (2) office and facility renovations, (3) aviation or other transportation services, and (4) 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 business. The ARRA does not specify any particular provisions required in such a policy, nor does it elaborate on what the policy should contain. Guidance from the Treasury Secretary will likely provide additional insight on this requirement, but until such guidance is issued, TARP Recipients should either avoid such expenditures, or to the extent they are incurred, retain records of them and of their underlying rationale.

Compensation Committee Requirements. Each TARP Recipient must establish a compensation committee, solely composed of independent directors, that will meet at least twice a year to review the TARP Recipient's employee compensation plans and assess any risk posed to the TARP Recipient as a result of such plans. A company whose common or preferred shares are not registered under the Exchange Act that receives less than $25 million in TARP funds must fulfill this requirement with its full board of directors.

Shareholder Say on Pay. Any proxy or consent for a shareholder meeting of a TARP Recipient must allow the TARP Recipient's shareholders to separately vote on whether they approve of the compensation provided to the TARP Recipient's executives, as disclosed per the SEC's rules (*e.g.,* the compensation discussion and analysis section and compensation tables). This shareholder vote is advisory; it is non-binding and cannot be construed to impose additional fiduciary duties on, or override, the TARP Recipient's board of directors.

The ARRA instructs the SEC to provide final rules and regulations regarding this requirement within one year. This statutory language initially led some commentators to believe that TARP Recipients might not have to comply with this requirement until those rules and regulations are issued. However, on February 20, 2009, Senator Dodd, who authored this requirement, sent a letter to the SEC expressing his view that this requirement applies to any TARP Recipient filing a proxy after the passage of the ARRA. Citing (although not necessarily endorsing) Senator Dodd's letter, the SEC has issued guidance for the upcoming proxy season. TARP recipients should monitor the developments on this issue carefully to determine their filing obligations.

(See http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm for the SEC guidance issued to date regarding the say on pay requirement.)

Compliance Certification. The CEO and CFO of each TARP Recipient must provide written certification that the TARP Recipient has complied with the restrictions listed above. Publicly traded companies must provide such certification in their annual filing, and private companies must provide such certification to the Treasury Secretary. The SEC stated that its view is that TARP recipients do not have to comply with this requirement until the Treasury Secretary establishes the "executive compensation and corporate governance standards" to which the certification applies.

Closing Comments

As mentioned above, the ARRA's executive compensation provisions are often ambiguous and vague. Guidance from the Treasury Secretary is expected to resolve some of these issues, but until that guidance is issued, TARP Recipients should consider options for retaining flexibility to make subsequent modifications. Additionally, they may need to strike a balance when interpreting these requirements so that they do not reach a conclusion that is too aggressive or too conservative. A too aggressive interpretation could result in punitive action from the Treasury Department, while a too conservative interpretation could cause unintended consequences (*e.g.*, delaying a bonus payment while waiting on Treasury guidance to clarify whether such payment is permissible under the rules could create deferred compensation and trigger penalties under Section 409A of the federal tax code). In addition, these executive compensation restrictions may complicate the recruitment and retention of qualified executives, and TARP Recipients may want to consider carefully how these restrictions will impact their recruitment and retention strategies.

Katten's TARP Task Force

Katten Muchin Rosenman LLP's multidisciplinary TARP Task Force advises clients on the U.S. Treasury's Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008. Katten's TARP Task Force can advise clients on determining how the executive compensation rules apply to them and structuring their compensation arrangements appropriately. Katten's TARP Task Force also can advise clients with respect to all aspects of other TARP-related programs, such as the Capital Purchase Program and Capital Assistance Programs whereby the U.S. Treasury is purchasing preferred shares in certain financial institutions, the Term Asset-Backed Securities Lending Facility (TALF) whereby the Federal Reserve will provide leveraged loans collateralized by newly issued consumer asset-backed securities, and the Private-Public Investment Fund whereby the government will provide assistance to private-sector entities to purchase troubled assets.

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