STIMULUS BILL AMENDS RESTRICTIONS ON EXECUTIVE COMPENSATION UNDER TARP

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA). Title VII of ARRA amends Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA), which established restrictions on executive compensation (EESA Restrictions) paid by financial institutions participating in the Troubled Assets Relief Program (TARP) under Title I of EESA (TARP Participants) (please visit: http://www.arnoldporter.com/resources/documents/CA_EmergencyEconomicStabilizationAct-ImpactOnExecComp_100908.pdf for an overview of the EESA Restrictions). ARRA's executive compensation and corporate governance provisions expand the EESA Restrictions and go well beyond the guidelines on executive compensation issued by the Department of the Treasury (Treasury) on February 4, 2009 (February 4 Guidelines) for institutions participating in the generally available capital access program (CAP) and institutions receiving exceptional financial assistance (please visit: http://www.arnoldporter.com/resources/documents/CA_TreasuryAnnouncesNewRestrictionsonExecutiveCompensation_021209.pdf for an overview of the February 4 Guidelines). This Client Advisory provides an overview of ARRA's executive compensation and corporate governance provisions.

I. TREASURY TO IMPLEMENT EXECUTIVE COMPENSATION STANDARDS THAT WILL APPLY TO ALL TARP PARTICIPANTS

ARRA directs Treasury to issue regulations establishing stringent standards for executive compensation (ARRA Standards). The ARRA Standards will apply during the period that a TARP Participant has an outstanding obligation to the federal government under TARP (TARP Obligation Period), but specifically excluding periods during which the federal government holds only warrants to purchase the TARP Participant's common stock. Unlike the February 4 Guidelines, the ARRA Standards will apply to all TARP Participants, including those who received TARP assistance prior to the enactment of ARRA.

II. NEW RESTRICTIONS ON EXECUTIVE COMPENSATION

- **Prohibition on Bonuses, Retention Awards, and Other Incentive Compensation.** The most publicized and perhaps most controversial aspect of the ARRA Standards is the prohibition on the payment or accrual of any bonus, retention award, or incentive compensation (collectively, incentive compensation) by a TARP Participant to certain employees, subject only to a limited exception for grants of restricted stock.

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— **Restricted Stock Exception.** The ARRA Standards permit grants of restricted stock, provided that (i) the restricted stock does not vest until after the end of the TARP Obligation Period, and (ii) the value of the restricted stock does not exceed one-third of the employee's total annual compensation. ARRA authorizes Treasury to specify additional terms and conditions for these limited grants of restricted stock.

— **Affected Employees.** The number of employees to whom this restriction applies depends upon the amount of financial assistance the TARP Participant has received. For institutions receiving less than US$25 million, the restriction applies only to the most highly paid employee. For institutions receiving at least US$25 million, but less than US$250 million, it applies to the five highest paid employees. For institutions receiving at least US$250 million, but less than US$500 million, it applies to the 15 highest paid employees. For institutions receiving at least US$500 million, it applies to the 25 highest paid employees.

— **Grandfathered Payments.** The incentive compensation restriction does not prohibit the payment of any bonus required to be paid pursuant to a written employment contract that was executed on or before February 11, 2009. The statutory language refers only to bonuses, so it is unclear whether this grandfathering provision also applies to retention awards and other incentive compensation.

- **Prohibition on Plans that Encourage the Manipulation of Earnings.** The ARRA Standards include a new prohibition on the establishment of any compensation plan that would encourage the manipulation of a TARP Participant's earnings to enhance the compensation of any TARP Participant's employees.

III. PRIOR RESTRICTIONS RETAINED AND EXPANDED

- **Prohibition on Golden Parachutes.** The ARRA Standards significantly expand the restriction on golden parachute payments. Under the expanded restriction, a TARP Participant is prohibited from paying golden parachute payments to its ten highest paid employees. ARRA defines "golden parachute payment" broadly to include any payment (other than payments for services performed or benefits accrued) relating to an executive's departure from the TARP Participant for any reason. The ARRA Standards go beyond the February 4 Guidelines, which require CAP participants to limit severance payments for their top five executives to 1x annual compensation, and institutions receiving exceptional assistance to pay no severance to their top ten executives and no more than 1x annual compensation to their next 25 executives. The EESA Restrictions limited severance to 3x the "base amount" under Section 280G of the Internal Revenue Code (Code) for a TARP Participant's top five executives. Notably, ARRA's golden parachute provisions go well beyond the longstanding golden parachute restrictions found in 12 U.S.C. 1828(k) and 12 C.F.R. Part 359 (relating to golden parachutes paid by banks in "troubled condition").

- **Clawback Requirement.** The ARRA Standards expand the requirement under EESA and the February 4 Guidelines that a TARP Participant claw back incentive compensation that was paid based on financial statements or other performance metrics that are later found to be materially inaccurate. Under ARRA, the clawback requirement applies to a TARP Participant's 25 highest paid executives. This requirement is in addition to the ARRA requirement discussed in the next section that Treasury review all incentive compensation already paid to the top 25 executives at existing TARP Participants for potential repayment directly to the federal government. The February 4 Guidelines apply the clawback requirement to the top five executives and to the next 20 highest paid employees only if they knowingly engaged in providing inaccurate information relating to the financial statements or other performance metrics that were used to calculate their own incentive compensation. The EESA Restrictions applied the clawback requirement only to the top five executives.

- **Prohibition on Incentives to Take Risk.** The ARRA Standards retain, essentially without modification, EESA's prohibition on incentives for the five highest paid executives to take unnecessary and excessive risks that threaten the value of the TARP Participant.

IV. TREASURY TO REVIEW PAST PAYMENTS BY TARP PARTICIPANTS

ARRA directs Treasury to review all bonuses, retention awards, and other compensation paid to the 25 most highly paid employees of existing TARP Participants prior to the enactment of ARRA to determine whether any such payments were inconsistent with the ARRA Standards or TARP or were otherwise contrary to the public interest. If Treasury makes such a determination, it is required to negotiate with the TARP Participant and the employee for reimbursement of the funds to the federal government.

V. ENHANCED CERTIFICATION AND CORPORATE GOVERNANCE REQUIREMENTS

- **Annual Certification of Compliance.** Under ARRA, a TARP Participant's CEO and CFO must provide a written certification of compliance with the applicable executive compensation restrictions. For publicly traded TARP Participants, the certification must be provided to the Securities and Exchange Commission (SEC). For TARP Participants that are not publicly traded, the certification must be provided to Treasury. This certification requirement is similar to the one imposed under the February 4 Guidelines, which require a TARP Participant's CEO (but not CFO) to certify compliance with all statutory, Treasury, and contractual restrictions on executive compensation. Under EESA, a TARP Participant's Compensation Committee was required to certify compliance only with the prohibition on incentives that encourage unnecessary and excessive risk.
- **Establishment of a Board Compensation Committee.** A TARP Participant is required to establish a Board Compensation Committee comprised entirely of independent directors who meet at least semiannually to discuss and evaluate the risk posed to the TARP Participant by its employee compensation arrangements. If a TARP Participant receives US$25 million or less in TARP assistance and its stock is not registered under the Securities Exchange Act of 1934, the TARP Participant's Board of Directors is required to carry out these duties.
- **Say on Pay Required.** During the TARP Obligation Period, any proxy, consent, or authorization for an annual or other meeting of the shareholders of a TARP Participant must permit a separate non-binding shareholder vote to approve the compensation of executives. The SEC has one year from the date of ARRA's enactment to issue regulations on this requirement.
- **Limits on Excessive or Luxury Expenditures.** A TARP Participant is required to establish a company-wide policy regarding excessive or luxury expenditures. ARRA authorizes Treasury to identify what constitutes an excessive or luxury expenditure, which may include: (i) entertainment or events, (ii) office and facility renovations, (iii) aviation or other transportation services, or (iv) 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.

VI. RELAXED RULES ON REPAYMENT OF TARP FUNDS

ARRA provides that Treasury, in consultation with the appropriate federal bank regulatory agency (if any), must permit a TARP Participant to repay any previously provided TARP assistance, without regard to any applicable waiting period or whether the TARP Participant has replaced its TARP assistance with funds from another source. Once the TARP assistance has been repaid, Treasury must liquidate the warrants associated with such assistance at the current market price. It does not appear that Treasury is permitted to deny a request to repay TARP assistance, even if such a repayment would stress an institution's capital, although presumably, an institution's federal regulator could take steps to prohibit repayment through its enforcement authority under the Federal Deposit Insurance Act.

VII. LIMIT ON TOTAL COMPENSATION

ARRA does not place any limit on the total compensation a TARP Participant can pay to its top executives. The February 4 Guidelines, however, generally limit total compensation for senior executives to US$500,000, plus certain qualifying grants of restricted stock (participants in CAP, but not institutions receiving exceptional assistance, can waive the limit if certain conditions are satisfied). It is not clear if the limit contained in the February 4 Guidelines will continue to apply or if Treasury will include a total compensation limit in the standards it is required to establish under ARRA. Treasury may not be inclined to impose an overall limit in view of the strict limitations on incentive compensation under the ARRA Standards (which as described above, only permit grants of a limited amount of restricted stock). The combination of an overall compensation limit and the limitations on incentive compensation could discourage financial institutions from participating in TARP and encourage existing TARP Participants to exit TARP under the relaxed repayment rules.

VIII. REACTION FROM THE OBAMA ADMINISTRATION

President Obama signed ARRA notwithstanding his and Treasury's concerns over ARRA's executive compensation provisions, particularly with respect to incentive compensation and the relaxed rules regarding the repayment of TARP funds. White House and Treasury officials have expressed a desire to revise these restrictions following the enactment of ARRA. Any such revisions, however, may require further legislative action.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney, or:

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