

BRAVE NEW WORLD: NEW EXECUTIVE
COMPENSATION RESTRICTIONS FOR COMPANIES
PARTICIPATING IN THE TROUBLED ASSET RELIEF
PROGRAM (TARP)

February 17, 2009

To Our Clients and Friends:

On February 13, 2009, the American Recovery and Reinvestment Tax Act of 2009 (the “Act”) was enacted, and the President is scheduled to sign it into law today. Among its many provisions, the Act includes broad restrictions and limitations on executive compensation for any company receiving financial assistance under the Troubled Asset Relief Program (“TARP”) established under the Emergency Economic Stabilization Act of 2008 (“EESA”). The restrictions included in the Act apply to both prior recipients of TARP funds and recipients of TARP funds in the future. The Act also loosens repayment restrictions under EESA by permitting any TARP recipient to repay any funds previously received without regard to whether the recipient has replaced such funds from another source or to any waiting period, subject to consultation with the appropriate Federal banking agency. This provision, a “Get Out of Jail Free” card of sorts, appears to be a nod to a small number of TARP recipients that have expressed a desire to pay back the government’s investment as quickly as possible rather than be subject to the governmental scrutiny imposed by EESA and the Act.

EXPANSION OF EXISTING TARP RESTRICTIONS

The Act generally incorporates the compensation restrictions originally imposed under EESA. EESA’s restrictions were intended to apply to an institution’s chief executive officer and chief financial officer, and the next three highest paid executive officers, determined on the basis of public company proxy reporting rules (the “Top Five Officers”), and prohibited incentives that encourage them to take “unnecessary and excessive risks”; required the institution to have procedures to claw back incentives paid to the Top Five Officers that were paid based on materially inaccurate financial statements; and prohibited “golden parachute” payments to the Top Five Officers (generally defined as severance payments equal to or more than three times an officer’s average historical compensation). The Act expands these requirements, as reflected in the following chart:

<u>Original EESA Restriction</u>	<u>Expansion under the Act</u>
Imposes compensation limits that exclude any incentives for the Top Five Officers to take unnecessary or excessive risks that threaten the value of the recipient of TARP funds	No material change
Requires repayment of any bonus or incentive compensation paid to any of the Top Five Officers if the payment was based on statements of earnings gains or other criteria that are later found to be materially inaccurate	Expanded to cover, in addition to the Top Five Officers, the next 20 most highly compensated employees (whether or not officers); also expanded to cover retention awards in addition to incentive compensation
Prohibits any “golden parachute payments” to any of the Top Five Officers	Expanded to cover, in addition to the Top Five Officers, the next five most highly compensated employees (whether or not officers); in addition, reduces the amount of permitted severance to zero

NEW RESTRICTIONS

Pay Limits. During the period in which a government investment is outstanding, a TARP recipient is generally prohibited from paying or accruing *any* bonus, retention award or incentive compensation to specified employees of the TARP recipient, as follows:

<u>Amount of TARP Assistance</u>	<u>To Whom the Provision Applies</u>
Less than \$25 million	The most highly compensated employee only
At least \$25 million and less than \$250 million	The five most highly compensated employees (or such higher number determined by Treasury)
At least \$250 million and less than \$500 million	The Top Five Officers and the next 10 most highly compensated employees (or such higher number determined by Treasury)
\$500 million or more	The Top Five Officers and the next 20 most highly compensated employees (or such higher number determined by Treasury)

These restrictions do not apply to “long term” restricted stock that (1) does not “fully” vest while government assistance remains outstanding, (2) has a value that is one-third or less of the total amount of annual compensation of the employee receiving the restricted stock and (3) is subject to such other terms and conditions as Treasury may determine is in the public interest. These restrictions also do not apply to any bonus payment required to be paid pursuant to a written employment contract executed before February 11, 2009.

This provision should properly be viewed as a significant milestone in recent Federal legislative activity. Efforts to influence corporate behavior regarding executive compensation have, since the 1980s, centered around deduction limitations (Sections 162(m) and 280G of the Internal Revenue Code) and/or additions to normal income taxes (Sections 4999 and 409A of the Internal Revenue Code) rather than outright controls. In addition, although there has been a recent effort by the SEC to invigorate public disclosure of executive compensation (through the new Compensation Discussion & Analysis and revamped proxy tables), the SEC’s stated view has been that it is concerned solely with disclosure rather than the amount of pay.

There will be significant commercial pressure placed on the interpretation of this provision, since TARP recipients could be at a distinct disadvantage in competing for talent with other entities that have not accepted government investment. Key interpretive questions include:

- How will the “highly compensated” employees be identified? That is, will the criteria be based on the prior year’s compensation, or will the Act present the risk of circularity in that the highly compensated group may change based on eligibility for the restricted stock awards?
- What is “long-term” restricted stock?
- May the restricted stock partially vest so long as it does not “fully” vest?
- What components of pay are contemplated within the term “annual compensation”?
- Will the “written employment contract” apply to bonuses that have been announced but not yet paid?
- Will Treasury by regulation increase the number of covered employees or impose “other terms and conditions” on pay?

In addition to these interpretive questions, it remains to be seen how TARP recipients will respond as a commercial matter to these compensation restrictions and whether Treasury or public opinion will tolerate workarounds discussed in recent press articles (such as substantial increases in base salary).

Generic Prohibition. The Act adopts, as a new compensation standard, the prohibition of any compensation plan that encourages manipulation of the reported earnings.

Independent Compensation Committee. Each recipient of TARP funds must establish a compensation committee comprised solely of independent directors for the purpose of reviewing employee compensation plans. The compensation committee must meet at least semiannually to discuss and evaluate the plans “in light of an assessment of any risk posed to the TARP recipient from such plans.” For TARP recipients that are not public and have received \$25 million or less in TARP funds, the duties of the committee can be carried out by the full board of directors. The Act does not seem to require that the committee be charged with making actual compensation determinations, and it will be interesting to see whether Treasury will allow the committee’s mandate to be limited solely to the stated statutory purpose.

Annual Certification. The CEO and CFO of a TARP recipient must annually certify compliance with the Act’s provisions. Thus, like the financial certifications required under Sarbanes-Oxley, the Act puts a TARP recipient’s most senior executive officers at risk for noncompliance with the Act.

More to Come on Luxury Expenditures. Boards of directors of recipients of TARP funds are required to adopt company-wide policies regarding “excessive or luxury expenditures” identified by Treasury, such as entertainment, office renovations and aviation and transportation services. Like an episode of “Law and Order,” each of these listed items appears to have been ripped from the headlines concerning the reported activities of certain of the recipients of TARP funds.

Say on Pay. Each recipient of TARP funds that is a public company must permit a separate, non-binding shareholder vote on executive compensation as part of its annual proxy meeting process. The Act charges the SEC with issuing regulations with respect to this provision within the year after enactment. It is not yet clear how this provision will apply to the 2009 proxy season. “Say on pay” shareholder resolutions have been a staple of activist shareholders for years and usually have failed to receive enough shareholder support to pass. It will be interesting to see whether the Act’s legislative imprimatur will cause this issue to gain momentum with respect to other public companies generally.

Loss of Deductibility. The Act codifies §162(m)(5) of the Internal Revenue Code as applying to all TARP recipients. Section 162(m)(5) provides that any compensation in excess of \$500,000 for services rendered by a covered executive of a TARP recipient in any year in which the government continues to have an interest in the TARP recipient will not be deductible for Federal income tax purposes. “Covered executives” for this purpose include the TARP recipient’s chief executive officer and chief financial officer and the next three highest paid other officers (determined in the same manner as for a public company’s annual proxy reporting, although in a slightly different manner than applies to the Top Five Officers). Once a person is a covered executive, he or she remains a covered executive for all subsequent years. None of §162(m)’s otherwise applicable exceptions – including the exemption for performance-based compensation – applies in respect of this provision.

Review and Renegotiation of Previously Paid Compensation. The Act requires Treasury to review any bonuses, retention awards and other compensation paid to Top Five Officers and the next 20 most highly compensated employees (whether or not officers) before the date of enactment of the Act to determine whether any of these payments were excessive or inconsistent with the purpose of the Act or TARP or otherwise contrary to the public interest. If so, Treasury is directed to negotiate the return of any such amounts to the government, although it is not given the authority to compel the return of any payments. TARP recipients would therefore be well-advised to review and document their prior compensation decisions, as it should be expected that Treasury may require the TARP recipient to produce all relevant documents in connection with its mandated review.

* * *

Prior and future TARP recipients are entering a brave new world in which their actions with respect to executive compensation will be limited and subject to close government scrutiny. For the time being, traditional concepts of sound business judgment and adequate disclosure, while still of paramount importance, will be part of a more complicated process by which compensation decisions are made by TARP recipients. While waiting for guidance from Treasury as to the scope of the Act’s new provisions, TARP recipients and those likely to become TARP recipients in the future should begin an internal compliance review and should also identify any changes to their compensation programs that may be required. It would be prudent for TARP recipients to assume that their executive compensation processes and decisions will ultimately become public and, accordingly, the range of possible public reaction to them should be taken into account.

This memorandum was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.

Jonathan F. Lewis

+1 212 909 6916

jflewis@debevoise.com

Lawrence K. Cagney

+1 212 909 6909

lkcagney@debevoise.com

Elizabeth Pagel Serebransky

+1 212 909 6785

epagelserebransky@debevoise.com

Charles E. Wachsstock

+1 212 909 6943

cewachsstock@debevoise.com