



## Client Alert

# Financial Markets Developments

### Stitching Together the Executive Compensation Rules for TARP Companies

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the Act). The Act amends the executive pay restrictions and standards that apply to companies that receive monetary assistance from the federal government pursuant to the Troubled Asset Relief Program (TARP Recipients). The Act closely follows the February 4 announcement by the White House and the US Department of Treasury of yet another round of changes to the executive pay restrictions for companies receiving TARP assistance.

#### Background

The executive pay rules applicable to TARP Recipients were established under the Emergency Economic Recovery Act of 2008 (EESA). The Treasury Department announced two separate programs pursuant to Section 111(b) of EESA—the Capital Purchase Program (CPP) and the Program for Systemically Significant Failing Institutions (PSSFI).

The CPP and PSSFI imposed restrictions on the executive pay of a TARP Recipient's top five most highly-compensated executives, whose compensation is required to be reported pursuant to the proxy disclosure rules (and the comparable employees of a non-public company), each a senior executive officer (SEO). To ensure that public funds are directed only toward the public interest in stabilizing the financial system and strengthening the US economy, the White House, quickly followed by Congress, tightened the executive pay standards.

#### Key Restrictions in the Act

The Act expands and restates the executive compensation and corporate governance rules of EESA. The rules of the Act apply to TARP Recipients for any period during which any obligation arising from financial assistance provided under the TARP remains outstanding, excluding periods during which the Federal government only holds warrants to purchase common stock of the TARP recipient (the TARP Assistance Period). The standards and procedures of the Act are summarized below. This may not be an exhaustive list of all such restrictions and rules that may apply to affected companies, however, as the Act provides the Treasury Department with broad authority to "require each TARP recipient to meet appropriate standards for executive compensation and corporate governance."

- **US\$500,000 Deduction Limitation.** A TARP Recipient cannot deduct for Federal income tax purposes more than US\$500,000 per year for compensation paid to each SEO. *The CPP and PSSFI imposed this same tax deduction limitation, by requiring TARP recipients to agree to this restriction.*
- **Incentive Pay Limitation.** A TARP Recipient is generally prohibited from paying (or accruing) any bonus, retention award, or incentive compensation to an SEO (except for bonuses required



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to be paid pursuant to a valid written employment contract executed on or before February 11, 2009, as determined by the Treasury Department). There is a significant exception for restricted stock that (a) does not fully vest until the government is repaid, (b) has a value that does not exceed  $\frac{1}{3}$  of the CEO's annual compensation and (c) is subject to any other terms and conditions that the Treasury Department determines are in the public interest. The number of executives affected by this restriction ranges from one to 25 (subject to increase by the Treasury Department), depending on the level of assistance provided to the TARP Recipient.

Assistance	Covered Employee
Below US\$25 million	The most highly-compensated employee.
US\$25 million; below US\$250 million	At least the five most highly-compensated employees.
US\$250 million; below US\$500 million	CEOs and at least the next 10 most highly-compensated employees.
Over US\$500 million	CEOs and at least the next 20 most highly-compensated employees.

*EESA, prior to the Act, and the related CPP and PSSFI (collectively, the prior rules), did not impose any such express limitation on bonuses and incentive compensation.*

**Note:** These rules taken together may have some paradoxical results. They may encourage TARP Recipients to increase salary and other fixed compensation relative to incentive compensation that varies based upon performance, which would be at odds with the “pay for performance” compensation philosophies of most corporations. Additionally, corporations may determine that recruitment and retention objectives outweigh any lost tax deduction in deciding whether or not to limit CEO compensation to US\$500,000 per year.

- **Excessive Risk-Taking.** Each TARP Recipient must exclude incentives that encourage CEOs to take unnecessary and excessive risks that threaten the value of the company. *The prior rules imposed this same restriction.*

- **Discourage Manipulation of Earnings.** Each TARP Recipient is prohibited from maintaining any compensation plan that would encourage manipulation of the reported earnings of the company to enhance the compensation of any of its employees. *The prior rules did not impose this restriction.*

- **Clawback.** Each TARP Recipient must include a “clawback” provision to recover any bonus, retention award, or incentive compensation paid to an CEO or any of the next 20 most highly-compensated employees, which is based on materially inaccurate financial statements or other criteria. *The prior rules only subjected the CEOs to a clawback provision.*

- **No Golden Parachute Payments.** Each TARP Recipient is prohibited from making “golden parachute payments” to an CEO and any of the next five most highly-compensated employees for their departure from the company for any reason (i.e., no severance payment at all, other than payments for services performed or benefits accrued). *The prior rules prohibited golden parachute payments in connection with an CEO's involuntary termination or the TARP Recipient's bankruptcy, insolvency or receivership. Unlike the CPP, which permitted severance pay up to three times the CEO's five-year average compensation, the current law is similar to the PSSFI, which prohibited any severance pay. However, the prior rules' golden parachute payment limitations applied to CEOs only.*

- **“Say on Pay” Shareholder Vote.** Each TARP Recipient must include within its annual proxy statement a nonbinding shareholder vote to approve the compensation of executives. On February 24, 2009, the Securities and Exchange Commission (SEC) issued additional guidance, clarifying that this “say on pay” provision is only required for the annual meeting of shareholders for which proxies will be solicited for the election of directors (or a special meeting in lieu of such annual meeting). Further, the “say on pay” requirement is not applicable to smaller reporting companies that are not required to provide a compensation discussion and analysis under the proxy disclosure rules. *The prior rules did not impose any “say on pay” requirement.*

- **Luxury Expenditure Policy.** Each TARP Recipient's board of directors must adopt a company-wide policy regarding excessive or luxury expenditures, as identified by the Treasury Department,

which may include excessive expenditures on: (a) entertainment or events; (b) office and facility renovations; (c) aviation or other transportation services; and (d) other activities or events not reasonable for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the TARP Recipient's business operations. *The prior rules did not require a company to adopt a luxury expenditure policy.*

- **Board Compensation Committee.** Each TARP Recipient must establish a Board Compensation Committee, comprised of independent directors, which meets at least semiannually to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the TARP Recipient from such plans. The duties of the Board Compensation Committee are to be fulfilled by the full board of directors of any TARP Recipient that (a) has received US\$25 million or less of TARP assistance and (b) does not have common or preferred stock registered under the Securities Exchange Act of 1934. *Similarly, the CPP and PSSFI required the compensation committee to meet at least annually with the senior risk officers to discuss and review the relationship between the financial institution's risk management policies and practices and the CEO incentive compensation arrangements.*
- **Annual CEO and CFO Certifications.** The CEO and CFO of each TARP Recipient must provide written certification of compliance with the executive compensation restrictions to the SEC (if publicly traded) or the Treasury Department (if not publicly traded). *The CPP and PSSFI required the compensation committee to annually certify it has reviewed, with senior risk officers, the CEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage the CEOs to take unnecessary and excessive risks that threaten the value of the institution. This certification was to be provided in the Compensation Discussion & Analysis portion of a company's proxy statement (if publicly traded) or filed with the primary regulatory agency (if not publicly traded).*
- **Treasury Review of Prior Payments to Executives.** The Act gives the Treasury Department the authority to review bonuses, retention awards, and other compensation paid to CEOs and

the next 20 most highly-compensated employees of each entity receiving TARP assistance before enactment of the Act, to determine whether any such payments were inconsistent with the purposes of the Act or TARP or were otherwise contrary to the public interest. If the Treasury Department makes such a determination, the Act directs it to negotiate with the TARP Recipient and the applicable employee for appropriate reimbursements to the Federal government with respect to the compensation or bonuses. Note that there is no limit on how far back the Treasury Department could go for review. *The prior rules did not provide for a retroactive clawback triggered by inappropriate executive pay, as determined by the Treasury Department.*

**Note:** The Act does not specify the method for determining highly compensated employees other than the CEOs for purposes of the incentive pay limits, clawback requirement, golden parachute prohibitions, and the Treasury Department's review of prior payments (e.g., the types of compensation that are counted on determining the affected employees, the year in which such determination is based, and whether tax or SEC principles are applied).

#### **Restrictions Announced by the White House**

Shortly prior to enactment of the Act, on February 4, 2009, the White House and the Treasury Department issued a press release announcing new restrictions on executive compensation for companies that will receive exceptional assistance after the date of the announcement in the form of company-specific negotiated agreements under the TARP program. The White House also proposed additional restrictions, which would be applicable to companies participating in the TARP under terms applicable to all recipients, with limits on the amount each company may receive and specified returns for taxpayers (the generally available capital access program). For information on these restrictions, please see our client alert entitled "[Here We Go Again...New Executive Pay Restrictions on Companies that Receive Bailout Funds.](#)"

Many of the restrictions in the Act are similar to those announced by the White House and Treasury Department on February 4. However, the Act did not cap CEO compensation (other than restricted stock) at US\$500,000 per year.

## Observations

The Act does not specify the effective date for its executive compensation requirements.

- Some provisions are already in effect with respect to the CEOs under the prior rules (e.g., the deduction limitation, ban on excessive risk-taking, clawbacks, and prohibition on golden parachute payments under the PSSFI).
- Other provisions should be implemented immediately as a matter of best practices (i.e., discourage the manipulation of earnings, adopt a luxury expenditure policy, and establish a board compensation committee).
- The Act expressly provides that the incentive pay restriction is prospective and does not apply to valid legacy contracts entered into on or before February 11, 2009.
- On February 24, 2009, the SEC clarified that the “say on pay” requirement became effective on February 17, 2009 and applies to preliminary or definitive proxy statements filed with the SEC after February 17, 2009. However, definitive proxy statements which relate to preliminary proxy statements filed on or before February 17, 2009 are not subject to this requirement.
- It is unclear whether certain provisions are currently in effect in the absence of further guidance from the SEC or Treasury Department, as required by the Act (e.g., the CEO and CFO certifications within upcoming proxy statements, clawbacks with respect to employees other than the CEOs, and the prohibition on any golden parachute payments under the CPP and with respect to employees other than the CEOs).

However, we are expecting interpretative guidance regarding the Act, as well as the interaction between the Act, the White House press release and surviving elements of the prior Treasury Department guidance, which should clarify this issue.

It remains to be seen whether the enhanced executive compensation restrictions of the Act will encourage companies to withdraw from the TARP. More generally, these restrictions may be establishing a platform for further executive compensation reform applicable to all industries. Due to the changing executive compensation landscape, all companies (beyond TARP Recipients) may want to rethink their compensation philosophy, restructure pay arrangements for a broader group of executives, assess how their compensation programs affect risk taking, revamp their corporate governance procedures and enhance executive compensation disclosures to generally align with the TARP requirements.

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