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Latest Restrictions on Compensation of Executives at Financial Institutions Receiving Assistance Under the Troubled Asset Relief Program

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OVERVIEW OF THE LATEST DEVELOPMENTS

The American Recovery and Reinvestment Act of 2009 ("*ARRA*") that became law on February 17, 2009, imposes new restrictions on compensation of certain executives at financial institutions that receive assistance under the Troubled Asset Relief Program ("*TARP*") under the Emergency Economic Stabilization Act of 2008 ("*EESA*"). This is in addition to the compensation restrictions recently announced by the Treasury Dept. ("*Treasury Guidelines*") in its February 4th press release (http://www.treasury.gov/press/releases/tg15.htm) covering executive compensation paid by those financial institutions (for example, Bank of America) receiving "exceptional financial recovery assistance".

AFFECTED EMPLOYEES

ARRA's provisions apply to "senior executive officers" ("*SEOs*") and to up to 20 of the next most highly-compensated employees. A "senior executive officer" is defined as "1 of the top 5 most highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and regulations issued thereunder, and non-public company counterparts." Under the Securities Exchange Act of 1934, disclosure of compensation paid is required only with respect to the "Principal Executive Officer" and the "Principal Financial Officer" on the basis of their respective responsibilities rather than the amount of their compensation and then the 3 most highly-paid executive officers. Thus, the SEOs for a given year will at a minimum be the 3 executive officers for whom disclosure is required due to the size of their compensation and will include the "Principal Executive Officer" and the "Principal Financial Officer" only if that officer is "1 of the top 5 most highly paid executives" for that year. Privately held participants in TARP are subject to these rules as if they were public and therefore, should familiarize themselves with these rules.

CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION LIMITATIONS UNDER AARA

1. ARRA imposes certain minimum corporate governance standards on both publicly held and privately held TARP participants and empowers the Treasury to impose additional standards. These minimum limitations are:

- **Limitations on Excessive Risk Taking**. Compensation of SEOs should not encourage the taking of "unnecessary and excessive risks that threaten the value" of the TARP participant while TARP obligations are outstanding. It would not be surprising for Treasury to apply this standard to all employees in light of recent revelations of the instability created by the actions of employees further down in an organization's hierarchy.

- **Clawback Provisions**. Recovery of compensation paid to SEOs and the next 20 most highly-compensated employees if such compensation was paid on the basis of criteria that is later found to be "materially inaccurate". How the group of 20 employees is to be identified is left to Treasury to develop guidelines. For example, once the group of 20 is identified and compensation is limited as discussed below, does this cause the next group of 20 highest paid employees to be affected? What about changes in the membership of this group from one year to the next?

- **Say on Pay**. Annual submission of the compensation of "executives" (to be defined by the Securities and Exchange Commission ("*SEC*") by February 17, 2010) to a non-binding vote by the TARP recipient's shareholders. In response to a letter from Sen. Christopher Dodd the SEC has adopted the view that ARRA's requirement for a non-binding shareholder advisory vote on executive compensation is applicable to proxy statements filed after February 17, 2009 (other than definitive proxy statements relating to preliminary proxy statements filed on or before February 17, 2009). The staff of the Corporate Finance Division of the SEC also has issued FAQs (which may be found at http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm) confirming that an institution that includes a proposal for an advisory vote will be required to file a preliminary proxy statement pursuant to Rule 14a-6(a) under the Securities Exchange Act of 1934. FAQs confirm that the advisory vote on executive compensation is not required for any meeting other than the annual meeting of shareholders or a special meeting in lieu of such annual meeting.

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- **General Corporate Governance**. Certification of compliance in a written statement signed by the CEO and CFO. In response to a letter from Sen. Christopher Dodd, the SEC position is that certification is not required until the Treasury Dept. has established the standards by which compliance is to be determined. Establishment of a compensation committee composed entirely of "independent directors" (definition left to the Treasury to develop) that will meet at least semi-annually to evaluate and assess the risk posed by employee compensation plans. This may prove to be redundant of what the SEC already requires in the case of publicly held companies.

2. ARRA imposes executive compensation limits on TARP recipients (both publicly held and privately held).

- **Golden Parachute Limitations**. "Golden parachute payments" to SEOs and the next 5 most highly-compensated employees while TARP obligations are outstanding is prohibited. "Golden parachute payment" is defined differently from the current definition under IRC § 280G. Under ARRA a "golden parachute payment" is defined as any payment to an SEO triggered by departure from employment, other than payments for services already performed or for benefits already accrued. Further, for institutions receiving "exceptional financial recovery assistance" the Treasury caps golden parachute payments at one-year's compensation for at least the next 25 top-paid employees.

- **Bonus Restrictions**. Prohibition on payment, or accrual, of any bonus or other incentive compensation while TARP obligations are outstanding. However, an exemption is created for restricted stock that (i) does not fully vest until all TARP obligations are repaid, (ii) is limited in value to 1/3rd of the total annual compensation of the recipient (whether this value is measured at the time of grant or at the time of vesting is unclear), and (iii) any other terms the Treasury may impose. If assistance under TARP is less than $25,000,000, this limitation only applies to the most highly-compensated employee. As the level of TARP assistance increases the number of affected employees rises so that above $500,000,000 in TARP assistance this prohibition applies to the SEOs and at least the next 20 most highly-compensated employees. In addition, grandfathering is provided for bonus or other incentive compensation that the Treasury determines is required under a written employment contract executed no later than February 11, 2009. Note, the Treasury Guidelines, which are separate from ARRA's requirements, impose a total compensation cap of $500,000 for institutions receiving "exceptional financial recovery assistance" with an exception for restricted stock that does not vest until the TARP assistance is repaid, but there is no limitation on the value of the restricted stock under the Treasury Guidelines.

- **Luxury Expenditures**. Adoption of a company-wide policy on "luxury expenditures" defined by the Treasury (applicable at least to entertainment expenses, office renovations and aviation services).

FENWICK & WEST COMMENTARY

The foregoing rules and compensation limitations under ARRA are applicable only to companies that participate in TARP. We believe that this is just the beginning of legislative and regulatory efforts that will limit the scope and form of executive compensation and impose increased corporate governance requirements and shareholder involvement on publicly held companies.

It is possible that this year may bring a series of legislative and regulatory developments extending the above rules (or very similar ones) to all publicly held companies either through mandatory imposition of compensation limitations and governance requirements (the *Wall Street Journal* has reported several times on lobbying efforts for "say on pay" during the past few years) or through limits on the tax deductibility of compensation. It would also not be difficult to envision, in light of our experience with IRC § 409A (which imposes a 20% penalty tax on certain types of deferred compensation), higher tax rates that exclusively apply to executive compensation exceeding certain thresholds. Already the staff of the SEC has informally indicated that for 2009 and beyond, it expects the CD&A's of all registrants to discuss how the registrant's compensation practices limit excessive risk taking regardless of whether the registrant is a TARP participant.

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