

Economic Stimulus Bill Imposes New Compensation Standards On Institutions Receiving TARP Assistance

The new executive compensation standards apply retroactively.

On February 17, 2009, the President signed into law H.R. 1, the American Reinvestment and Recovery Act of 2009, that includes new executive compensation standards applicable to financial and other institutions receiving governmental assistance under the Troubled Assets Relief Program (“TARP”) established by the Emergency Economic Stabilization Act of 2008. The new executive compensation standards are more stringent than those currently in effect or proposed by the U.S. Department of the Treasury (“Treasury”). Although applicable only to TARP recipients, all public companies should be aware of the new standards as some components likely will generate significant interest among institutional investors and other activist shareholders which will make them more broadly applicable.

Scope of Changes

The new executive compensation standards apply retroactively. However, the standards do not apply during any period in which the Federal government holds only warrants to purchase common stock of the TARP recipient. In addition, TARP recipients are permitted to repay the Treasury, without early penalty or having to raise additional capital, to avoid these standards.

In some public statements, President Obama has indicated discomfort with the new executive compensation standards which go beyond the earlier limitations announced by the Treasury. There is some suggestion that the Treasury may seek to limit the scope of these standards through

its regulations. As a result, it is unclear how these new standards will relate to the similar standards announced by the Treasury on February 4, 2009. However, the passage of H.R. 1 makes it unlikely that the Senate will consider the “TARP II” legislation passed by the U.S. House of Representatives earlier this year.

Summary of Changes

The new executive compensation standards expand the prior TARP compensation standards and, in many cases, expand compensation limitations beyond the TARP recipient’s senior executive officers (“SEOs”), defined as the top 5 most highly compensated executives of a public company. Significantly, the standards do not impose a hard cap on executive compensation, but do require the following:

- **Prohibition on Severance Payments.** TARP recipients are prohibited from making any severance payment upon a “departure from a company for any reason” to SEOs or any of the next 5 most highly compensated employees, except for “payments for services performed or benefits accrued.”
- **Review of Prior Bonuses.** The Treasury may review bonuses, retention awards and other compensation previously paid by TARP recipients to SEOs and the 20 next most highly compensated employees to determine whether such bonuses were “inconsistent with the purposes of this section or the TARP or otherwise contrary to public interest.”

The prohibition on bonus payments does not extend to the payment of any bonus required pursuant to a written employment contract executed on or before February 11, 2009 or the payment of long-term restricted stock.

If so, the Treasury will enter into “negotiations for reimbursement” of such amounts.

- **Prohibition on Bonuses.** TARP recipients are prohibited from paying or

accruing any bonus, retention award or incentive compensation to a specified number of employees based on the amount of TARP assistance received, as described in the table below.

Financial Assistance Provided to TARP Recipient	Application of Prohibition on Bonuses
Less than \$25M	Only the most highly compensated employee
\$25M but less than \$250M	5 most highly compensated employees*
\$250M but less than \$500M	SEOs and 10 next most highly compensated employees*
\$500M or more	SEOs and 20 next most highly compensated employees*

* The Treasury may specify a higher number if “in the public interest.”

Note: This prohibition does not extend to the payment of any bonus required pursuant to a written employment contract executed on or before February 11, 2009 or to the payment of long-term restricted stock. Any such restricted stock grants, however: (i) may not fully vest during the period in which any obligation arising from financial assistance provided to the TARP recipient remains outstanding; (ii) may not have a value that is greater than 1/3 of the employee’s total annual compensation; and (iii) are subject to any other terms imposed by the Treasury.

- **Nonbinding Say on Pay.** The proxy statements of TARP recipients must permit a nonbinding “Say on Pay” shareholder vote to approve the compensation of executives. It is unclear whether the shareholder vote will relate to the compensation of employees that are not SEOs.
- **No Bonus Plans that Encourage Manipulation of Earnings.** TARP recipients are prohibited from maintaining any compensation plan that would encourage manipulation

of reported earnings to enhance the compensation of any employee.

- **No Unnecessary Risk.** TARP recipients cannot maintain incentive compensation programs that encourage SEOs to take unnecessary and excessive risks that threaten the value of the institution.
- **Clawback.** Bonuses, retention awards and incentive compensation paid by TARP recipients to SEOs and the next 20 most highly compensated employees are subject to clawback if payment is based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.
- **Establish Compensation Committee.** Each TARP recipient must establish a Compensation Committee consisting entirely of independent directors for the purpose of reviewing employee compensation. This Compensation Committee (if the TARP recipient is not publicly traded and received \$25,000,000 or less of TARP assistance, the Compensation Committee is the entire Board of Directors) must meet

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at least semi-annually to discuss and evaluate compensation plans in light of an assessment of any risk posed to the TARP recipient from such compensation plans.

- Limitation on Luxury Expenditures. The Board of Directors of each TARP recipient must establish a company-wide policy regarding “excessive or luxury expenditures” including entertainment, parties, office and facility renovations, aviation or other transportation services, and other activities or events that are not reasonable expenditures.
- Compensation Deduction Limitation. TARP recipients may not claim a deduction for compensation paid to an SEO in excess of \$500,000 under Section 162(m)(5) of the Internal Revenue Code of 1986.
- Certification of Compliance. The chief executive officer and chief financial officer of each TARP recipient must provide a written certification of compliance with the new executive compensation standards to the Securities and Exchange Commission, if publicly traded, or to the Treasury, if not publicly traded.

Observations

The Treasury is directed to issue regulations implementing these new standards, which will provide further guidance and may resolve open issues. In the interim, TARP recipients should comply with the new executive compensation standards and consider the following:

- Definition of SEOs. SEOs are defined as the top 5 most highly compensated executives of a public company and not by reference to Federal securities laws. Accordingly, a company’s SEOs may not be identical to its “named executive officers” under Federal securities laws. The Treasury is expected to adopt a definition of SEO by reference to Item 402 of Regulation S-K to align this definition

with Federal securities laws and to expand this definition to include private companies.

- No Limit on Base Salary. The new executive compensation standards do not limit base salary. As a result, increases in base salary are likely. Any TARP recipient increasing base salary to compensate for the loss of bonus opportunity must consider: (i) how to disclose increases in guaranteed compensation; (ii) whether the increased base salary could result in Say on Pay shareholder disapproval; and (iii) the loss of deductibility for CEO salary in excess of \$500,000.
- Limitations on Restricted Stock Grants. Although grants of restricted stock are permitted, TARP recipients should consider whether: (i) their equity plans permit restricted stock grants; (ii) their equity plans allow restricted stock to be granted on the terms and conditions required by the new standards; (iii) the maximum term of restricted stock grants will extend beyond the TARP assistance period; and (iv) a sufficient number of shares are available for grant, taking into account the plan’s share counting procedures and share authorization.
- Bonuses Required by Employment Agreements. It is unclear what level of specificity is required to allow for the payment of bonuses pursuant to a written employment agreement. The Treasury is expected to address this issue.
- Review of Prior Bonus Payments. It is unclear whether the Treasury may review bonuses paid prior to the receipt of TARP assistance and, if so, the length of the look-back period. TARP recipients that paid bonuses should maintain all supporting documentation relating to the payments in the event the bonuses are reviewed by the Treasury.

If you have any questions, please contact one of the following, or any member of the Vorys Financial Crisis Team.

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- **Change in Control Agreements.** Change in control agreements that provide for a severance payment upon a termination in connection with a change in control (i.e., a “double trigger”) are subject to the prohibition on severance payments because the ultimate trigger is a “departure” from the employer; however, change in control agreements that provide for payments solely on account of a change in control (i.e., a “single trigger”) are not subject to this prohibition.
- **Nonbinding Say on Pay.** Although the Say on Pay vote is nonbinding, Boards of Directors should consider whether applicable state law or their corporate governance documents create any obligation upon a negative vote.
- **Looking Ahead.** Although these restrictions are applicable only to TARP recipients, the inclusion of these standards in the stimulus legislation should be a clear signal to other employers that additional compensation changes will be forthcoming – whether imposed by the legislature or as part of institution governance checklists. These include Say on Pay, risk analysis of compensation, director independence and luxury expenditure policies.
- **Incentive Compensation Limits.** It is unclear the extent to which the vesting or settlement of previously granted equity awards (e.g., options, restricted stock, etc.) will be prohibited by the new executive compensation standards. Additionally, TARP recipients ability to grant options is also unclear.

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