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Executive Compensation

Last minute efforts to remedy potential abuses at firms receiving taxpayer funds have left many open issues. In this article, the authors reviewed the provisions of the economic stimulus act, The American Recovery and Reinvestment Act of 2009, and discuss issues raised by the act. The authors also consider the impact of future congressional efforts to ''fix'' shortcomings in ARRA and earlier legislation and current regulations.

The Recovery Act's Mechanism to Stimulate the Economy Requires Adjustment: Is More Legislation the Answer?

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Background.

In tough economic times where Keynesian Economics has taken over, the new administration's attempt to ''stimulate'' the economy is to target corporate America's executive compensation standards and procedures. In this regard, on Feb. 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA),[1] also known as the economic stimulus act.

Last year, the Emergency Economic Stabilization Act of 2008 (EESA)[2] authorized the Secretary of Treasury to establish the Troubled Asset Relief Program (TARP). TARP allows the Secretary of Treasury to purchase troubled assets from a financial institution.

The ARRA amends EESA to strengthen restrictions and prohibitions on executive compensation. The ARRA imposes certain prohibition on bonuses and retention or severance payments to the most highly compensated employees of employers that receive funds from TARP. In addition, ARRA, limits the amount that may be deducted for executive compensation. ARRA not only applies prospectively to TARP recipients, but also retroactively. Even though certain contractual ar-

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[1] Pub. L. No. 111-5.

[2] Pub. L. No. 110-343.

rangements in existence prior of ARRA's enactment are grandfathered, the act requires the Secretary of Treasury to review previously paid bonuses, retention awards, or other compensation to the most highly compensated employees of a TARP recipient to determine if they are inconsistent or contrary to the public interest. Such payments will be subject to renegotiation by Treasury with TARP recipients and the subject employees to repay those amounts to the U.S. government. These restrictions remain intact until all TARP funds received by the company are returned to the government. Currently, there are over 400 companies receiving TARP assistance.[3]

One can ask, does this hastily drafted legislative approach filled with implementation and enforcement problems represent the future for executive compensation in all of corporate America?

This article addresses some of the implementation and enforcement problems, including but not limited to applying the controlled group rules to these restrictions and enforcing the law on TARP recipients with cross border affiliate subsidiaries within the controlled group. In addition, we note a March 17, 2009, announcement by Senate Finance Chairman Max Baucus (D. Mont.) and Ranking Member Charles Grassley (R-Iowa) of the core principles of a new proposal to address the gaps in the law and to recoup inconsistent payments by TARP recipients.[4] This latest proposal confirms the need for further adjustment in the legislation.

ARRA Executive Compensation and Corporate Governance Provisions.

Bonus Restrictions.

ARRA prohibits any TARP recipient from ''paying or accruing any bonus, retention award, or incentive compensation'' for its senior executives.[5] The number of executives this restriction applies to depends on the amount of TARP funds the company received. Specifically, the restriction apply on a graduated scale to executives at companies receiving the following amounts: (1) less than $25 million, the most highly compensated employee; (2) $25 million but less than $250 million, at least the five most highly compensated employees; (3) $250 million but less than $500 million, to the senior executive officers and at least the 10 next most highly compensated employees (or even a higher number if the Secretary of Treasury believes it would be in the public interest); and (4) $500 million or more, the senior executive officers[6] and at least the 20 next most highly compensated employees (or even a higher number if the Secretary of Treasury believes it would be in the public interest).[7]

ARRA provides an exception to the bonus restriction for long term restricted stock if certain conditions are met. ARRA requires that such stock: (1) cannot be vested prior to TARP funds be completely repaid; (2) the value of the stock cannot exceed one-third of an executive's annual compensation; (3) the stock is subject to terms imposed by Treasury deemed in the interest of the public.

Grandfathered Employment Agreements.

The restrictions imposed by ARRA on incentive compensation and bonuses do not apply to payments to be made pursuant to written employment contracts executed on or before Feb. 11, 2009.[8] ARRA requires that the Secretary of Treasury determine what constitutes a valid employment agreement.

Recent events have caused public outrage with respect to bonuses being paid based on prior contractual arrangements. While certain arguments are compelling, such as that without the TARP funds, the company would not be in existence, and as a result, there would no employment and no bonus, ARRA explicitly provides that prior contractual arrangement may be honored. In addition, arguments have been made that these bonuses should be paid in order to attract and retain the best and the brightest talent.

The alternative not to honor the contract, would subject the TARP recipient to breach of contract claims and costly litigation—to wit: more expenditure of TARP funds as corporate executives are most likely indemnified by the company.

This raises the question as to whether any analysis has been done to ascertain effects of litigation on a TARP recipient and its stakeholders (arguably the U.S. taxpayer).

First, has any thought been given to the need for or effect of civil litigation immunity to those TARP recipients charged with complying with ARRA requirements (unless acts of willful or wanton misconduct are present) to safeguard further taxpayer expenditures?

Second, will there ever be a time when the Secretary of Treasury must take legal action to recover bonuses paid under contracts grandfathered by ARRA, EESA, and TARP that are inconsistent with public policy? In such litigation, there is an inherent conflict of interest in that the Secretary of the Treasury's goal is to have TARP recipients repay the U.S. government and thrive on their own, ultimately bolstering the economy.

Another alternative: eliminate grandfathering. On March 17, 2009, Senators Baucus and Grassley introduced a proposal that, among other things, would institute a 70 percent excise tax to be paid by both the employee and employer. This excise tax would apply to all retention bonuses or other bonuses earned or paid beginning on Jan. 1, 2009, and continuing through the period that the company retains TARP funds. In essence, it appears they have taken the approach to breach existing contracts and remove the grandfathering provision of ARRA, at least with respect to payments made in 2009.

Other Incentive Compensation Prohibited; Deductible Limits and Clawback Provision.

The ARRA prohibits:

- incentives for senior executive officers that would encourage unnecessary and excessive risks, [9] and

[3] See http://www.treas.gov/initiatives/eesa/docs/transaction_report_03-16-09.pdf.

[4] See http://finance.senate.gov/press/Bpress/2009press/prb031709b.pdf.

[5] EESA § 111(b)(3)(D)(i), as amended by ARRA.

[6] EESA § 111(a)(1), as amended by ARRA, defines senior executive officers as the top most highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934.

[7] EESA § 111(b)(3)(D)(ii), as amended by ARRA.

[8] EESA § 111(b)(3)(D)(iii), as amended by ARRA.

[9] EESA § 111(b)(3)(A), as amended by ARRA.

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- any compensation plan for any employee that would encourage manipulation of reported earnings.[10]

Further, ARRA states that the $500,000 deductible limit under Section 162(m)(5) of the Internal Revenue Code applies to all recipient of TARP funds without any exception for performance-based compensation.[11]

ARRA provides a clawback provision wherein a TARP recipient may recoup any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees based on statements later found to be materially inaccurate.[12]

Golden Parachute Restrictions.

ARRA prohibits a TARP recipient from disbursing any golden parachute payments to a senior executive officer or any of the next five most highly compensated employees during the period the company maintains TARP funds.[13]

ARRA defines golden parachute payments as ''any payment to a senior executive officer for departure from the company for any reason, except for payments for services performed or benefits accrued.''[14] This definition is broader than previously defined under EESA, which defined golden parachute under Section 280G of the Internal Revenue Code. The previous definition would have allowed for severance benefits amounts up to three times the executive's average annual compensation. Unlike for former employment contracts, ARRA does not permit grand fathering of severance previously permissible under EESA.

Recovery Opportunity of Previously Paid Compensation to the U.S. Government. ARRA requires that the Secretary of Treasury review previously paid bonuses, retention awards, or other compensation made before Feb. 17, 2009, to senior executive officers and the next 20 most highly compensated employees of a TARP recipient.[15] In regards to such review, the Secretary of Treasury must determine whether payments made were inconsistent with ARRA, TARP, or contrary to the public interest. If the Secretary finds that such payments were inappropriate, Treasury must negotiate with the TARP recipient and the subject employee to have those amounts repaid to the U.S. government.

An issue that arises is whether there are any safeguards to enforce recovery of payments when payments are made cross-border. If payments are made overseas, one issue is whether the employees' receiving these bonuses are part of a controlled group, within the meaning of Section 414(b) of the Internal Revenue Code, and whether the payments are recoverable under ARRA. Section 414(b) provides that all employees of all corporations that are members of a controlled group of corporations are treated as employed by a single employer. Another issue arising in enforcement of the repayment provision is what happens when the overseas corporation ceases to be a member of the controlled group.

The concept that the Congress should have considered is whether these payments, which are funded through taxpayer monies, should be treated as ''trusted'' assets as under the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, plan fiduciaries may not maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.[16] This would ensure that enforcement capabilities are preserved.

On the other hand, the Baucus and Grassley proposal introduced the concept of collecting an excise tax of 35 percent from the individual employee. The proposal anticipates nonpayment by foreign employees by requiring collection through normal withholding, and making the company responsible for paying such employee's 35 percent excise tax amount.

Corporate Governance.

Under ARRA, TARP recipients are required to establish appropriate executive compensation and corporate governance standards.[17] Accordingly, each TARP recipient must establish a board compensation committee, comprised solely of independent directors. This board must meet twice a year to evaluate the TARP recipient's employee compensation plans and assess any risk such plans may impose.[18]

In addition, ARRA requires that the company's annual proxy statement include a nonbinding shareholder vote on the compensation of the company's executives.[19] In this regard, the Securities and Exchange Commission is mandated to issue final rules within a year. The SEC has provided temporary guidance by issuing Compliance and Disclosure Interpretations in question and answer format.[20] In the Q&As, the SEC stated that the nonbinding vote only has to take place at the annual meeting at which directors are elected. The SEC also stated that preliminary proxies must be filed with the SEC for a 10-day review period before a final proxy can be sent to shareholders. Further, according to a letter from Senator Christopher Dodd (D-Conn.), the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, to the SEC chairman, the effective date of this ''say-on-pay'' requirement is the date of enactment of ARRA and it applies to all proxies filed after Feb. 17, 2009.

ARRA also requires that the TARP recipient adopt a policy regarding excessive or luxury expenditures as identified by the Secretary of Treasury.[21] Excessive expenditures may include: (1) entertainment or events, (2) office or facility renovations, (3) aviation or other transportation services, or (4) 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.

Further, ARRA requires that the chief executive officer or chief financial officer certify to the SEC that the

[10] EESA § 111(b)(3)(E), as amended by ARRA.
[11] EESA § 111(b)(1)(B), as amended by ARRA.
[12] EESA § 111(b)(3)(B), as amended by ARRA.
[13] EESA § 111(c), as amended by ARRA.
[14] EESA § 111(a)(2), as amended by ARRA.
[15] EESA § 111(f), as amended by ARRA.

[16] ERISA § 404(b).
[17] EESA § 111(b)(2), as amended by ARRA.
[18] EESA § 111(c), as amended by ARRA. For nonpublicly traded companies that received $25 million or less in TARP funds, the provision permits the TARP recipient's own board of directors to carry out the duty to evaluate employee compensation plans.
[19] EESA § 111(e), as amended by ARRA..
[20] See American Recovery and Reinvestment Act of 2009, Feb. 26, 2009, available at http://sec.gov/divisions/corpfin/guidance/arrainterp.htm.
[21] EESA § 111(d), as amended by ARRA..

company is in compliance with ARRA.[22] Senator Dodd also opined in his letter to the SEC that this certification is not effective until the Treasury promulgates regulations and provides standards for executive compensation and corporate governance.

Repayment Conditions Lifted.

Under EESA, TARP recipients were required to retain cash for three years or raise amounts from third parties to replace it. ARRA allows for the repayment of TARP funds without the cash reserve requirement.[23] However, the repayment is subject to consultation by the Secretary of Treasury with the appropriate federal banking agency. The consideration surrounding this consultation is not described in ARRA. Once TARP funds are repaid, the Secretary of Treasury must liquidate any warrants it received at current market prices.

The March 17 Proposal. In addition to the concept of imposing an excise tax of 70 percent on retention bonuses, or bonuses over $50,000, Senators Baucus and Grassley want to extend restrictions further to individual deferred compensation. Among the principals they announced in their March 17 proposal (see above), is a provision to cap nonqualified deferred compensation at $1 million. Accordingly, employees will no longer be able to defer more than $1 million in a 12-month period. In its present form, the March 17 proposal exemplifies Congress's continued expansion of legislation to address issues that should have been, but were not, addressed in EESA, and later in ARRA. Thus, Congress is creating law in a patchwork fashion by enacting legislation to fix ineffective regulations.

Legislative Fix. Last minute efforts to remedy potential abuses have left many open issues. The administration and the Treasury need to go back and analyze these issues to avoid further public outrage over the use of taxpayer monies. Alternative options must be reviewed with respect to employment contracts already in effect and the possibility of renegotiating them due to public disgust over the use of tax payers' monies to pay employee bonuses at failing companies. Congress cannot issue sweeping legislation and expect it to be effective. It will only cause further disruption in corporate economic affairs when *economic stimulus* is the ultimate goal.

[22] EESA § 111(b)(4), as amended by ARRA. Nonpublicly traded companies must have the CEO or CFO certify compliance with the Treasury.

[23] EESA § 111(g), as amended by ARRA.

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