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A Financial Institutions Legal Update

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Treasury Issues Guidance on TARP Standards for Compensation and Corporate Governance

Much-anticipated Treasury Regulations were published yesterday in the form of “Interim Final Rules” (“IFRs”) and generally are *effective immediately* (with a few exceptions), providing guidance on the American Recovery and Reinvestment Act of 2009 (the “ARRA”) that became law in mid-February 2009.

The ARRA imposed significant new compensation limitations and corporate governance requirements on financial institutions that receive financial assistance under the Troubled Asset Relief Program (“TARP”). Lane Powell analyzed the ARRA’s impact on TARP recipients in a March 5, 2009, Financial Institutions Update, available at http://www.lanepowell.com/wp-content/uploads/2009/05/fi_2009_0004.pdf. At only five pages long, the portion of the ARRA that deals with compensation and corporate governance is full of ambiguities and is heavily dependent on the IFRs and other Treasury guidance.

The IFRs – all 123 pages of them, including the preamble – provide much of the needed detail that was lacking regarding executive compensation restrictions and corporate governance rules for TARP recipients.

The following is a brief overview of some of the more important rules:

- Definition of a “TARP recipient” is expanded to include entities in a parent-subsidary relationship with the TARP recipient and any related entities created to avoid or evade the TARP restrictions.
- Payments cannot be delayed in order to avoid the TARP restrictions.
- Once identified, a TARP recipient’s senior executive officers (“SEOs”) and most highly compensated employees remain in place for a full year.
- Salary and other compensation can be paid in stock of the TARP recipient – so long as the stock is not subject to a substantial risk of forfeiture (*i.e.*, so long as it is taxable upon receipt).
- The restrictions do not apply in cases where the TARP recipient has repaid its obligation and federal government *only* holds warrants to purchase common stock of the TARP recipient.

- An excessive and luxury expenditures policy must be adopted, filed with the Treasury department and posted on the company’s website within 90 days of the effective date of the Regulations (*i.e.*, by September 19, 2009).
- Prohibited “golden parachute” payments include amounts payable due to a change in control.
- Prohibitions are imposed on tax “gross-ups” or other reimbursements for the payment of taxes to any of the CEOs and next 20 most highly compensated employees – whether on a formal or informal basis – except for certain international tax leveling purposes.
- TARP recipients must annually disclose to Treasury and its primary federal regulator any perquisites whose total value exceeds \$25,000 for any employee who is subject to bonus payment limitations.
 - Additionally, the TARP recipient must identify the amount and nature of each perquisite and disclose a justification for offering the perquisites.
- TARP recipients must annually disclose to its primary federal regulator and to the Treasury department whether the TARP recipient, the board, or the compensation committee has engaged a compensation consultant and all types of services the compensation consultant or any of its affiliates provided during the past three years, including any “benchmarking” or comparisons employed to identify certain percentiles of compensation (*i.e.*, “peer group” company comparisons).
- Different definitions of “compensation” are used for different purposes. For example, a definition of compensation that includes equity compensation awards valued on the date of *grant* is used to determine the amount of restricted stock that can be granted to an CEO or certain highly compensated employees, but compensation as defined under federal securities law regulations – a definition that includes equity compensation valued on the date of *payment (not grant)* – is used to determine whether an executive is a “highly compensated” employee.
- Compensation committees are required to be established by September 19, 2009; each such committee must consider and provide annually a “narrative description” of how it limited executive compensation plans to: (1) eliminate elements that could encourage CEOs to take unnecessary and excessive risks, (2) avoid unnecessary exposure to risk (including a focus on short-term results rather than on long-term value creation) and (3) discourage the manipulation of the TARP recipient’s reported earnings.
- The ARRA “clawback” requirements are different (and much broader) from those required under section 304 of the Sarbanes-Oxley Act of 2002 – and companies are required to exercise clawback rights unless they can demonstrate that it is unreasonable to do so (*i.e.*, that the expense of enforcement would exceed anticipated recoveries).
- ARRA imposed significant restrictions on bonus, incentive compensation and retention award payments to CEOs and certain highly compensated employees; the IFRs define what pay is considered subject to these restrictions:
 - A “bonus” means any payment in addition to any amount payable to an employee for work performed by the employee at a regular hourly, daily, weekly, monthly or similar periodic rate. This excludes:

- Contributions to qualified retirement plans;
- Benefits under broad-based benefit plans;
- *Bona fide* overtime pay;
- Routine expense reimbursements; and
- Commission compensation for sales to, and investment management services for, unrelated parties.
- The IFRs include an “anti-abuse” rule: payments that would be subject to the bonus restriction but are delayed and paid in a subsequent year when the executive is not subject to the rules may be recharacterized as a payment of an impermissible bonus.
- “Incentive compensation” is defined in reference to Federal securities regulations. This means that stock option or stock plans are considered incentive compensation whether or not those plans are subject to performance-based vesting.
- “Retention awards” are broadly defined as any payment that is a bonus but which is: (1) contingent on the completion of future services, (2) not based on the completion of a specific project and (3) not based on the employee’s performance or the business activities or value of the TARP recipient. This includes amounts paid under “make whole” agreements intended to provide a newly hired employee a continuation of benefits accruing at a former employer.
 - Excluded as a retention award: amounts accrued under non-qualified deferred compensation plans (*i.e.*, supplemental executive retirement plans (SERPs)), but only to the extent amounts are accrued “in the normal course of the employee’s service”: an accrual due to a material enhancement of a plan may be considered a prohibited retention award.
- A key exception to the ARRA’s prohibition on bonuses, incentive payments and retention awards involves awarding restricted stock to CEOs and certain other highly compensated employees.
 - The IFRs clarify that for purposes of the exception, “restricted stock” includes both restricted stock and restricted stock units. This is welcome relief for TARP recipients which are smaller, family-owned community banks and other private financial institutions for which grants of restricted stock would be impractical or impossible.
 - The IFRs also provide that stock or units granted under the plan must:
 - require the executive to perform services for at least two years after the grant; and
 - be subject to a schedule under which the stock becomes transferable or units become payable, as the case may be. Under this schedule, for each 25 percent of total financial assistance repaid, 25 percent of the stock/stock units granted may become transferable/payable until the final repayment.
- Amounts awarded to an executive who was not subject to the ARRA bonus restrictions at the time of grant may become subject to the prohibitions if in the future that executive later becomes subject to the prohibitions. In such case, payment would be required to be delayed until the executive no longer is subject to the prohibitions.

- Imposes records retention rules, requiring the preservation of documentation and records to substantiate all required certifications for at least six years.
- Confirms that the provision of false information or certifications may result in criminal penalties.
- Authorities of the Special Master (Pay Czar) are generally limited to “exceptional assistance” TARP recipients (*i.e.*, AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial). However, all TARP recipients can apply to the Special Master for an advisory opinion with respect to compensation payments and structures to gain assurances of their compliance with the new statutory and regulatory requirements.

Effective Date: As noted above, the IFRs are generally effective on their June 15, 2009, publication. However, the rules provide that bonus payment limits will not apply to bonuses, retention awards and incentive compensation paid or accrued prior to June 15, 2009, and enhanced golden parachute prohibitions will not apply to amounts paid prior to June 15, 2009. For more information, please contact the Financial Institutions Law Industry Team at Lane Powell:

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